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No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1992

MOUNTAIN WATER CO.,

Petitioner,

v.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, et al.,

Respondents.

Petition For A Writ Of Certiorari To The Supreme Court Of The State Of Montana

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

A Montana statute obligates privately owned water utility companies to pay over to their customers the costs of maintenance of customer-owned service lines. The statute has been adjudicated by the Court of Appeals for the Ninth Circuit to be a taking of the utility's property for which compensation must be paid under the fourteenth amendment. The Montana Public Service Commission represented to the federal courts that it would provide compensation to the water utility companies for the taking through increases in the rates charged to their customers. The questions presented are:

1. Did the Montana Public Service Commission violate the fourteenth amendment's requirement of just compensation for property taken for public use by denying a private water utility company compensation for money, taken from it under the state statute, on the ground that awarding the compensation due would contravene a general state policy against "retroactive ratemaking"?

2. Should this Court exercise its discretionary jurisdiction to protect the integrity of the federal judicial process by reversing a decision of the Montana Supreme Court which affirms the denial of compensation, through a rate increase, for a taking under the state statute, the facial constitutionality of which had previously been sustained by the federal courts on the basis of the Montana Public Service Commission's representation that compensation would be provided in the ratemaking process?

LIST OF PARTIES

The parties before the Montana Supreme Court were appellants Montana Department of Public Service Regulation, Montana Public Service Commission, and Montana Consumer Counsel* and respondent Mountain Water Co.** In this proceeding, the petitioner is Mountain Water Co., and the respondents are the Montana Department of Public Service Regulation, Montana Public Service Commission, and the Montana Consumer Counsel.

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*The Montana Consumer Counsel is an agency created by Mont. Const. art. XIII, § 2, App. 188, to represent the interests of consumers in hearings before the Montana Public Service Commission.

**Mountain Water Co. is a corporation organized under the laws of the state of Montana. It is a wholly owned subsidiary of Park Water Co., a corporation organized under the laws of the state of California. Mountain Water Co. has no corporate subsidiaries.

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PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF MONTANA

Petitioner Mountain Water Company respectfully petitions this Court for a writ of certiorari to review the judgment of the Supreme Court of the State of Montana in this case.

OPINIONS BELOW

The original opinion of the Montana Supreme Court is unreported. (App. 6). The opinion as modified following Mountain Water Co.'s petition for rehearing is reported in *Mountain Water Co. v. Montana Department of Public Service Regulation*, ___ Mont. ___, 835 P.2d 4 (1992), hereafter referred to as *Mountain Water II*. (App. 1). The court's unreported order modifying its original opinion and denying Mountain Water Co.'s petition for rehearing is reproduced at App. 92.

Mountain Water II was before the Montana Supreme Court on an appeal by the Montana Department of Public Service Regulation, Montana Public Service Commission and the Montana Consumer Counsel from a decision of the Montana First Judicial District Court. The case arose on Mountain Water Co.'s petition for judicial review of a decision by PSC in docket 89.6.23 denying, in part, Mountain Water Co.'s application for a rate increase. PSC's initial rate order and its order on reconsideration are

reproduced at App. 19 and App. 54, respectively.[1] The opinion of the Montana First Judicial District Court granting Mountain Water Co.'s motion for summary judgment is reproduced at App. 12.

Mountain Water Co. had earlier sought a declaration from the United States District Court for the District of Montana that the statute at issue in this case was unconstitutional on its face. The United States District Court for the District of Montana denied relief to Mountain Water Co. in an unpublished opinion granting PSC's motion for summary judgment. *Mountain Water Co. v. Montana Department of Public Service Regulation*, No. CV 87-92-H-CCL (July 20, 1988). (App. 81). The United States Court of Appeals for the Ninth Circuit affirmed this decision in an opinion reported in *Mountain Water Co. v. Montana Department of Public Service Regulation*, 919 F.2d 593 (9th Cir. 1990), hereafter referred to as *Mountain Water I*. (App. 64).

JURISDICTION

The judgment of which review is sought was final, for purposes of this Court's jurisdiction, upon the entry of the Montana Supreme Court's order denying Mountain Water Co.'s petition for rehearing on August 13, 1992. U.S.Sup.Ct.R. 13.4. The petition is jurisdictionally in time if filed on or before November 12, 1992. U.S.Sup.Ct.R.

[1] PSC denied the rate increase originally in Order 5449a. (App. 19). It declined to modify that decision on reconsideration in Order 5449b. (App. 54).

13.1, 30.1.[2] Jurisdiction in this Court exists pursuant to 28 U.S.C. § 1257(a) (1988), in that (1) this case presents a challenge to the validity of a state statute as being repugnant to the fourteenth amendment to the United States Constitution, as applied to Mountain Water Co., and (2) this case presents a denial by PSC, affirmed by the Montana Supreme Court, of a right to compensation guaranteed by the fourteenth amendment to the United States Constitution. *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304, 313 n.8 (1987) (hereafter referred to as "*First English*").

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case presents a challenge to the application by PSC of Mont. Code Ann. § 69-4-511 (1991), which provides:

> **Financial responsibility and liability for water service pipeline.** (1) A property owner is responsible for the costs of constructing privately supplied water service pipelines from the main to his premises and for maintaining service pipelines from his property line to his premises. The private water service provider is responsible for the cost of maintaining water service pipelines from the main to the owner's property line, except that the property owner

[2] The ninetieth day following August 13, 1992, is November 11, 1992. November 11 is a legal holiday, 5 U.S.C. § 6103(a) (1988), extending the due date for the petition to the following business day.

> shall pay for pipe and other supplies used in maintaining water service lines between the main and his property line.
>
> (2) A property owner is not liable for any injury or property damage associated with excavation in maintaining water service pipelines if the excavation does not occur between his property line and his premises.

The fifth and fourteenth amendments to the United States Constitution are reproduced at App. 183-184. 28 U.S.C. §§ 1257 and 1342 (1988) are reproduced at App. 186-187. Mont. Const. art. XIII, § 2, is reproduced at App. 188. Mont. Code Ann. tit. 2, ch. 4, pt. 7, and §§ 69-1-102, 69-3-101, 69-3-102, 69-7-101 (1991), are reproduced beginning at App. 189. Mont. R. App. P. 34 (1991) is reproduced at App. 198. Admin. R. Mont. 38.5.106 (1990) is reproduced at App. 199.

STATEMENT

Mountain Water Co. is a privately owned utility company providing municipal water service to the city of Missoula, Montana and the town of Superior, Montana. As a privately owned utility, it is regulated by the Montana Public Service Commission (hereinafter "PSC"), an entity created by the Montana legislature for the purpose, *inter alia*, of regulating public utilities. Mont. Code Ann. § 69-1-102 (1991). (App. 194).[3]

[3] Under Montana law, municipal water systems owned by local governments are, with some exceptions, self-regulated. Privately owned municipal water systems are regulated by PSC.

In 1987, the Montana legislature enacted Mont. Code Ann. § 69-4-511 (1991). The statute requires privately owned water companies to reimburse their water customers for costs incurred in repairing and maintaining that portion of the water service line between the water main and the customer's property line. The water service lines are the property of the customer under Montana law. Thus, the statute obligates Mountain Water Co. to give its money to its customers to reimburse them for costs they incur in maintaining their own property.

Mont. Code Ann. § 69-4-511 (1991), establishes no mechanism for providing just compensation for the property it takes from Mountain Water Co. Montana has a general policy against using the ratemaking process as a recovery mechanism for past losses.[4] Under PSC's policy, utility rates are made prospectively on the basis of cost of service data generated during a dated, historic test year.[5]

Mont. Code Ann. §§ 69-7-101, 69-3-101, 69-3-102 (1991). (App. 195-197).

[4] The policy was created by PSC, and has been sustained by the Montana Supreme Court in, *e.g.*, *City of Helena v. Montana Department of Public Service Regulation*, 194 Mont. 173, 634 P.2d 192 (1981).

[5] Under PSC's rules, rates are based on costs actually incurred in a representative historic test year. The rule allows adjustments to the historic test year costs only for known and measurable changes in the costs incurred in the test year. Admin. R. Mont. 38.5.106 (1990). (App. 199). *See* discussion *infra* at n.17 and accompanying text.

On the date Mont. Code Ann. § 69-4-511 (1991) became effective, Mountain Water Co. filed an action for declaratory judgment in the United States District Court for the District of Montana, seeking a declaration that the statute violated the Takings Clause of the fourteenth amendment[6] by taking the property of Mountain Water Co. without just compensation and for a non-public use.[7]

In response to the complaint, PSC conceded that the statute took the property of Mountain Water, but asserted that the taking was for a public use and that Mountain Water would be compensated for all property taken through the ratemaking process. The district court found this argument persuasive and entered summary judgment for PSC. (App. 85-86).

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[6] The Takings Clause of the fifth amendment is applicable to actions of the states by incorporation through the fourteenth amendment. *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 160 (1980). For clarity, the takings issue is referred to in this petition as arising under the fourteenth amendment.

[7] The complaint for declaratory judgment raised a constitutional challenge under the Equal Protection Clause as well. The statute requires privately owned water companies to reimburse their customers for water line repairs and maintenance, but does not place a similar obligation on publicly owned utilities. The federal district court found a rational basis for this differing treatment, a holding which the Court of Appeals for the Ninth Circuit affirmed on appeal. *Mountain Water I*, 919 F.2d at 596-599 (App. 69-72). The Equal Protection challenge was not renewed in the state court proceedings which gave rise to this petition, and accordingly is not before the Court for review.

Mountain Water Co. appealed this decision to the Court of Appeals for the Ninth Circuit. The court of appeals affirmed, but on the basis of its belief, derived from PSC's representations, that PSC would compensate Mountain Water Co. to the full extent of its losses under the statute. The court found that the statute took Mountain Water Co.'s property, a point which was not seriously contested. *Mountain Water I*, 919 F.2d at 599. (App. 74). It held that the statute did not violate the fourteenth amendment on its face, however, accepting PSC's assertion that under Montana law Mountain Water Co. would be compensated through the ratemaking process. *Id.* at 600 ("Only if the PSC's rate order fails to compensate Mountain Water for all of its private property dedicated to public use can Mountain Water complain of a violation of its Fifth Amendment rights.") (App. 78).

Mountain Water filed a rate case before PSC in 1989, before the Ninth Circuit's decision was announced, including a request to be compensated for the property taken from it under the statute as soon as it could reflect the taking in its filing in accordance with PSC regulations.[8] PSC, despite its representations to the federal courts that the ratemaking process afforded Mountain Water Co. a mechanism for payment of compensation for its payments under Mont. Code Ann. § 69-4-511 (1991), denied Mountain Water Co. the rate relief requested as

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[8] It was undisputed before PSC and in the courts below that Mountain Water Co. had expended a total of $165,108 under the compulsion of Mont. Code Ann. § 69-4-511 (1991), in 1988 and 1989. See, e.g. Order on Petition for Judicial Review at 8. (App. 18).

compensation for the taking.[9] PSC invoked, as justification for denying Mountain Water Co. compensation for the property taken under the statute, its general policy against "retroactive ratemaking." (App. 33-35).

Mountain Water Co. sought judicial review of PSC's order in the Montana First Judicial District Court.[10] The district court granted Mountain Water Co.'s motion for summary judgment, ordering PSC on remand to adopt a rate which compensated Mountain Water Co. for the taking which had occurred under Mont. Code Ann. § 69-4-511 (1991), in 1988 and 1989. The court held, following the reasoning of the Ninth Circuit Court of Appeals in *Mountain Water I*, that the statute could survive a challenge under the Takings Clause only if the ratemaking procedure actually compensated Mountain Water Co. for the takings which had occurred under the statute. (App. 15). Since the rate order at issue in this case did not compensate Mountain Water Co. for the takings which had occurred in 1988 and 1989, the district court remanded the case to PSC with directions to grant the rate increase necessary to compensate Mountain Water Co. for the money it had paid out under compulsion of the statute in 1988 and 1989. (App. 17-18).

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[9] PSC allowed a rate increase for payments to be made *in the future* under Mont. Code Ann. § 69-4-511 (1991), using the actual amount taken from Mountain Water Co. in 1988 as an estimate of expenses to be incurred under the statute in the future. *Mountain Water I*, 835 P.2d at 5. (App. 3).

[10] The Montana Administrative Procedure Act affords judicial review of PSC rate orders in Montana's district courts. Mont. Code Ann. tit. 2, ch. 4, pt. 6 (1991). (App. 189).

PSC appealed this decision to the Montana Supreme Court, which reversed. The court held that PSC could deny Mountain Water Co. compensation for the 1988 and 1989 takings because of a general policy against "retroactive ratemaking," which the court defined as "set[ting] rates so as to amortize past deficits." *Mountain Water II*, 835 P.2d at 6. (App. 4). The court found that Montana law did not authorize PSC to include in the rates losses incurred in past years, and that Mountain Water Co. therefore could not be compensated through the ratemaking process for money taken from it under Mont. Code Ann. § 69-4-511 (1991), in 1988 and 1989. *Id.* (App. 5).

PRESENTATION OF QUESTIONS IN PROCEEDINGS BELOW

Mountain Water Co. first raised the issues presented here in a brief filed before PSC in the rate proceeding the appeal of which culminated in this petition. In the brief, Mountain Water Co. argued that the failure of PSC to compensate Mountain Water Co. for losses sustained under the statute in 1988 and 1989 would deprive it of its property without just compensation and would be inconsistent with representations made by PSC before the federal courts. (App. 98).[11] Mountain Water Co. raised the

[11] The briefs in which the issues were raised were in some cases quite lengthy. For brevity, the appendix to the petition contains excerpts of the briefs demonstrating that these issues were fairly raised before PSC and the Montana courts. The Montana Supreme Court specifically found that the federal constitutional issue was properly raised and never suggested that any state law procedural bar allowed it to avoid addressing the

issues again in its motion for reconsideration of PSC's initial order denying compensation. (App. 105, 111-112).

Mountain Water Co. raised the issues again in its petition for judicial review of PSC's rate order before the Montana First Judicial District Court, and in its briefs in support of its motion for summary judgment before that court. (App. 119, 123, 131-133). The issues were presented to the Montana Supreme Court in Mountain Water Co.'s brief on appeal. (App. 137-146). Mountain Water Co. presented the issues again in its petition for rehearing, which it timely filed following the entry of judgment on the appeal by the Montana Supreme Court. (App. 148).[12]

REASONS FOR GRANTING THE WRIT

The Court should grant a writ of certiorari in this case for three reasons. First, the decision of the Montana Supreme Court in *Mountain Water II* conflicts directly with the decision of the Ninth Circuit Court of Appeals in *Mountain Water I* on an important issue of federal constitutional law. In *Mountain Water I*, PSC argued to the federal courts, successfully, that Mont. Code Ann. § 69-4-511 (1991), did not deprive Mountain Water Co. of

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federal question. *Mountain Water II*, 835 P.2d at 5 (App. 1); *see infra* n.14.

[12] Under Mont.R.App.P. 34 (1991), a petition for rehearing is timely if filed within ten days after the entry of judgment by the Montana Supreme Court. (App. 198). The Montana Supreme Court entered its initial judgment on the appeal on July 21, 1992. Mountain Water Co. filed its petition for rehearing on July 30, 1992.

its property without just compensation because Mountain Water Co. would be compensated for the taking through the rate process. In reliance on PSC's interpretation of Montana law, the federal courts denied Mountain Water Co. relief. Having fought off the facial constitutional challenge in *Mountain Water I* by asserting that Mountain Water Co. would be compensated, PSC then turned around and denied compensation in *Mountain Water II*, a decision which the Montana Supreme Court affirmed.

In light of the Ninth Circuit's holding that the opportunity for compensation through ratemaking saved the facial constitutionality of the statute, the Montana Supreme Court was clearly wrong in holding that the rate order denying compensation to Mountain Water Co. was constitutional. This Court should grant certiorari to resolve this conflict.

The second reason for granting the writ in this case is the conflict between the Montana Supreme Court's decision in this case and this Court's decision in *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). In *First English*, this Court held that compensation must be paid for past economic losses which amount to a taking and which are incurred as a result of state statutory law. The Montana Supreme Court ignored the holding in *First English* and denied Mountain Water Co. compensation for its property taken under the statute, even though it has been specifically held by the Ninth Circuit, and conceded by PSC from the very beginning, that Mont. Code Ann. § 69-4-511 (1991), takes the property of Mountain Water Co. in a manner requiring compensation under the fourteenth amendment.

The Court should also grant certiorari because the Montana Supreme Court's decision sanctions an abuse of the federal judicial process. The Takings Clause of the fourteenth amendment affords Mountain Water Co. important protections against the taking of its property without just compensation. In this case, the State of Montana has deprived Mountain Water Co. of its property, through the enactment and enforcement of Mont. Code Ann. § 69-4-511 (1991). PSC has refused to provide the constitutionally required compensation, despite (1) having told the federal courts that compensation would be provided through rates and (2) being told by the Ninth Circuit Court of Appeals in clear and unequivocal terms that the entry of a rate order which does not compensate Mountain Water Co. for "all" the property taken from it under the statute would violate the Due Process Clause.

The State of Montana has no license to mislead the federal courts as to the effect of its laws. State courts likewise have no license to ignore important federal constitutional rights. It is respectfully submitted that the Ninth Circuit Court of Appeals could not have reached the conclusion it reached in *Mountain Water I* absent PSC's misrepresentations as to the ability of Mountain Water Co. to recover compensation for the taking through the ratemaking process. This Court should grant certiorari and reverse the Montana Supreme Court's decision to protect the integrity of the federal judicial process.

1. This Court has frequently granted certiorari to resolve a conflict between a decision of a federal court of appeals, on the one hand, and the decision of the highest court of a state on the other, as to an important issue of federal law. *See, e.g., Lakeside v. Oregon*, 435 U.S. 333, 336

& n.3 (1978); *Andresen v. Maryland*, 427 U.S. 463, 470 n.5 (1976). In this case, the conflict arises in two appellate court decisions, one federal and one state, stemming from the same dispute.

In *Mountain Water I*, the United States Court of Appeals for the Ninth Circuit held that Mont. Code Ann. § 69-4-511 (1991) could survive facial constitutional attack because Montana law afforded a mechanism for compensation through rates. The court stated:

> [O]nly if the PSC's rate order fails to compensate Mountain water justly for *all* of its private property dedicated for public use can Mountain Water complain of a violation of its fifth amendment rights. * * * *Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order*, but not the statute, *unconstitutional.*

919 F.2d at 600 (emphasis added). (App. 78-79).

It is implicit in the court of appeals' analysis that a rate order which did not compensate Mountain Water Co. for "all of its private property taken for public use" would violate the fourteenth amendment. The court of appeals sustained the statute because its understanding of Montana law, drawn from representations made by PSC, led it to believe that a rate order would be entered which would meet the fourteenth amendment's requirements, by compensating Mountain Water Co. for "all" of its losses sustained under Mont. Code Ann. § 69-4-511 (1991).

The court of appeals acknowledged in its opinion that Mountain Water Co. had raised a concern about the

effect of the rule against "retroactive ratemaking." 919 F.2d at 600. (App. 77).[13] The court dealt with Mountain Water Co.'s concern by holding, in the language quoted above, that a rate order which failed to provide compensation for "all" property taken would have to be held unconstitutional. *Id.* (App. 78-79).

The Montana Supreme Court's view of the fourteenth amendment issue, on review of the denial by PSC of the requested rate relief, differs markedly from that of the court of appeals. The Montana Supreme Court clearly acknowledged that Mountain Water Co. had raised an issue of federal constitutional law. *Mountain Water II*, 835 P.2d at 5. (App. 1).[14] Unlike the Ninth Circuit, however, the Montana Supreme Court held that Mountain Water

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[13] The court of appeals stated:

> Under Mountain Water's analysis, then, the liability statute's taking of these funds necessitates a judicial eminent domain action, just as the taking of a parcel of land would so necessitate. *Unlike judicial eminent domain proceedings, Mountain Water points out, PSC rate setting is prospective. PSC rate setting therefore, cannot compensate Mountain Water dollar-for-dollar for the funds the utility must transfer to its customers.*

(Emphasis added).

[14] The Montana Supreme Court stated:

> We frame the following issue for appeal: Whether the Public Service Commission's refusal to authorize recovery through prospective rate setting of past period § 69-4-511, MCA, expenses did not justly compensate Mountain Water Company, *in violation of the Fifth and Fourteenth Amendments to the United States Constitution* and of Article II, Section 29 of the Montana Constitution.

(Emphasis added).

Co. can be denied compensation for money taken from it under the statute for the sole reason that Montana's rate-making policies do not allow PSC to provide the compensation. *Id.* at 6. (App. 4-5).

This case does not present the difficult valuation problems with which this Court has grappled in cases such as *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The property which has been taken for public use in this case is money, which Mountain Water Co. is required to pay over to its customers. *Cf. Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 164 (1980) (fourteenth amendment protects creditor's interest in interpleaded fund). Moreover, this case does not present a dispute over whether Mountain Water Co.'s property is taken by the statute. *Cf. Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) (Pennsylvania statute precluding amortization in utility rates of cost of plants not built held not a taking). In this case, it has never been disputed that the statute takes the property of Mountain Water Co. The Ninth Circuit specifically held that the statute worked a taking, *Mountain Water II*, 919 F.2d at 599 ("We agree with the district court and the parties in this case that by requiring Mountain Water to reimburse its customers for repairs to their privately-owned service lines, [Mont. Code Ann. § 69-4-511 (1991)] effects a taking of Mountain Water's property.") (App. 74).

The Montana Supreme Court's decision is truly unprecedented. No decision of this Court has ever held, as the Montana Supreme Court did in *Mountain Water II*, that a utility company's property can be taken, under a statute specifically adjudicated to be a taking under the fourteenth amendment, without compensation, simply

because "[h]istorically, utility companies do not receive retroactive rate increases." *Mountain Water II*, 835 P.2d at 6. (App. 4). When it enacted a statute taking Mountain Water Co.'s property, the State of Montana was obligated by the fourteenth amendment to provide just compensation for all property taken. *Mountain Water I*, 919 F.2d at 600. (App. 77-78). The Montana Supreme Court's decision relieves the State of Montana of its obligation under the United States Constitution to compensate Mountain Water Co. for the taking.

The issue presented in this petition is important and will repeatedly arise, if the Montana Supreme Court's improper view of the fourteenth amendment's just compensation guarantee is not corrected. Mountain Water Co. will be presenting rate cases to PSC in the future. PSC has held, in the rate order before the Court in this case, that the prospective rate relief afforded Mountain Water Co. in this rate order and in future rate orders will be based on expenses incurred in past years, and that no adjustment will be made to compensate Mountain Water Co. for any losses not recovered in the prospective rates. (App. 34-35). Thus, whenever Mountain Water Co.'s expenses under the statute exceed the amount incurred in the historic test year used to compute its rates, Mountain Water Co. will receive less than full compensation for the property taken from it under the statute.

The Montana Supreme Court has effectively informed PSC that it is free to deny Mountain Water Co. compensation for money taken under the compulsion of Mont. Code Ann. § 69-4-511 (1991), whenever Montana's "rules involved in rate-making" suggest that result. Mountain Water Co. will repeatedly be in jeopardy of

receiving less than the constitutionally required just compensation for money taken from it under the statute unless this Court acts to reverse the Montana Supreme Court's decision. The Court should grant the writ to force the State of Montana to comply with the law enunciated by the Ninth Circuit in *Mountain Water I.*

2. In *First English,* this Court held unequivocally that financial compensation must be paid by a state when property is taken for public use. The Court reversed a decision of the California Court of Appeals which had held that a complaint in inverse condemnation did not state a claim upon which relief could be granted under the fourteenth amendment to the extent it sought damages for a regulatory action by the state which had not yet been adjudicated a taking by the courts. The decision of the Montana Supreme Court in this case conflicts in principle with the *First English* holding.

In *First English,* the California courts held that the plaintiff was not entitled to a trial on its claim that a land use regulation worked a taking of its property. The state courts relied on the California Supreme Court's opinion in *Agins v. Tiburon,* 24 Cal.3d 266, 598 P.2d 25 (1979), *aff'd on other grounds,* 447 U.S. 255 (1980), in which the court had interpreted the fourteenth amendment to allow a state to deny compensation for a taking during the period prior to the time the courts adjudicated in a declaratory action that the regulation at issue was in fact a taking.

The California courts supported their view that compensation need not be paid until a regulatory statute is adjudicated a taking by a court on policy considerations supporting "freedom in the land-use planning function"

and opposing "the inhibiting financial force which inheres in the inverse condemnation remedy," *Agins*, 24 Cal.3d at 276-77, 598 P.2d at 31. This Court recognized the importance of such state law policies, but held that they "must be evaluated in light of the command of the Just Compensation Clause of the Fifth Amendment." 482 U.S. at 317. The Court held that these policies did not overcome the constitutional requirement that compensation be paid whenever a taking has occurred, stating: "We . . . hold that where the government's activities have already worked a taking of all use of property, no subsequent action by the government can relieve it of the duty to provide compensation for the period during which the taking was effective." 482 U.S. at 321.

The Montana Supreme Court failed to adhere to this admonition in this case. As in *First English*, the state courts have deprived a property owner of compensation on the basis of considerations of state policy. Such policies cannot overcome the fourteenth amendment's obligation to pay compensation, as the decision in *First English* makes absolutely clear. The Montana Supreme Court's decision cannot be squared with that holding by this Court.

The rationale relied upon by PSC in the courts below will not save the Montana Supreme Court's analysis. PSC urged the Montana Supreme Court to apply the rule that a taking only occurs, in the utility rate context, when a rate is set at a level which denies the utility a reasonable return on its investment. *See, e.g., Duquesne Light*, 488 U.S. at 307-312 (collecting cases). This analysis is inapposite

here because its goal is to determine *whether* a taking has occurred. Here, it has already been finally adjudicated by the federal courts in *Mountain Water I* that Mont. Code Ann. § 69-4-511 (1991) takes the property of Mountain Water Co. PSC has never denied that a taking occurs whenever the statute requires Mountain Water Co. to expend its funds to compensate a customer for maintenance expenses incurred under the statute. Reliance on the ratemaking cases to determine whether the rate charged is so unreasonable as to constitute a taking completely misses the point.

This Court made it clear in *First English* that the fourteenth amendment requires compensation whenever property is taken, regardless of state law policy considerations which argue against compensation. The decision of the Montana Supreme Court denying compensation because of the "policy" against retroactive ratemaking cannot be squared with the *First English* holding. The Court should grant the writ to bring the Montana Supreme Court's view of the fourteenth amendment's compensation requirement into compliance with this Court's decision.

3. The relationship between litigants and the federal courts is at issue in this case. PSC made representations to the federal courts that Mountain Water Co. would be compensated for the money it was forced by the statute to pay over to its customers.[15] The federal district court

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[15] The briefs filed in the United States District Court in *Mountain Water I* were made part of the record in the judicial review proceeding in *Mountain Water II* through, *inter alia*, a Joint Appendix filed in the Montana Supreme Court. Mountain

accepted those representations, and the court of appeals affirmed in reliance on the district court's opinion. *Mountain Water II*, 919 F.2d at 600 ("The district court held that Mountain Water's recourse as a utility to obtain just compensation for the property taken . . . is to seek rate increases before the PSC. We agree.") (App. 77).

Montana's general policy against retroactive ratemaking, which PSC invoked to deny Mountain Water Co. an increase in rates which would have returned to it the money it paid out under compulsion of the statute, was in existence at the time PSC made its representations to the federal district court. The cases cited by the Montana Supreme Court in *Mountain Water II* stating the general

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Water Co. relied on the briefs to support an argument that PSC was judicially estopped to deny Mountain Water Co.'s requested rate relief because of the statements PSC had made to the federal courts. The Montana Supreme Court rejected the assertion that PSC was judicially estopped. However, the court acknowledged that the representations in question were made, stating "The PSC admitted during the course of the federal litigation that § 69-4-511, MCA, was a taking *and that [Mountain Water Co.] would be compensated through ratemaking.*" 835 P.2d at 6 (emphasis added). (App. 3-4). The court found no judicial estoppel, in a perplexing ruling which effectively begged the question presented, stating that "in making that admission PSC did not waive application of the rules involving rate-making." *Id.* (App. 4). Judicial estoppel is a question of Montana law over which this Court lacks jurisdiction. However, the Court certainly has the power to grant certiorari and to reverse the Montana Supreme Court's decision as a means of forcing PSC to provide the compensation it assured the federal courts would be forthcoming. Excerpts of the briefs in which PSC's representations were made, as submitted in the Joint Appendix to the Montana Supreme Court, are reproduced at App. 167-182.

rule that "utilities may not set rates to amortize past deficits" date at least as far back as 1918.[16]

PSC's own rules clearly state that rates are set based on expenses actually incurred by the utility during a historic test year ending no more than nine months prior to the date of filing of the rate request. Mont. Admin. R. 38.5.106 (1990). (App. 199). The rule explicitly states that "no adjustments [to the historic test year costs] shall be permitted unless known with reasonable certainty and measurable with reasonable accuracy at the time of the filing." *Id.*[17]

Under these rules, Mountain Water Co. could not have reasonably anticipated that its losses under Mont. Code Ann. § 69-4-511 (1991) for 1988 and 1989 could be recoverable in rates until after they were "known and measurable." The first year in which *any* losses were incurred under the statute was 1988. Since a historic test

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[16] The Montana Supreme Court cited *City of Helena v. Montana Department of Public Service Regulation*, 194 Mont. 173, 634 P.2d 192 (1981); *Billings Utility Co. v. Public Service Commission*, 62 Mont. 21, 203 P. 366 (1921); and *State ex rel. City of Billings v. Billings Gas Co.*, 55 Mont. 102, 173 P. 799 (1918).

[17] The classic example of a change which meets the "known and measurable" standard is a change in labor expense under a collective bargaining agreement. For example, if Mountain Water Co. had had a collective bargaining agreement which raised its labor cost between the end of the 1988 test year and its 1989 rate filing, it would have been permitted to adjust its test year labor expense upward to reflect the higher wage rate payable under the collective bargaining agreement. The new wage rate is "known with certainty and measurable with reasonable accuracy at the time of filing" because the amount of the increase is specified in the bargaining agreement.

period must be twelve months in length, Mont. Admin. R. 38.5.106 (1990) (App. 199), under PSC's rules Mountain Water Co. could not have sought rate relief at all for charges incurred in 1988 and in that portion of 1989 which passed before the rate request was filed. The amount of money paid under the statute could not be predicted with any degree of accuracy. PSC specifically found in its rate order that "at the present time [statutory] expenses are volatile and not subject to the control of the utility."[18] They are thus the antithesis of a "known and measurable" change.

This Court has an affirmative role to play in preventing the undermining of the integrity of the federal judicial process. *Frazier v. Heebe*, 482 U.S. 641, 647 n.7 (1987). The Montana Supreme Court has rewarded PSC for its actions, holding that even though PSC told the federal courts that Mountain Water Co. would be compensated in the rate making process, PSC "did not waive the application of the rules involved in rate-making." *Mountain Water II*, 835 P.2d at 6. (App. 4). Mountain Water Co. cannot seek review in the federal courts with respect to the rate order at issue here.[19] This Court must act by granting the writ and reversing the Montana Supreme Court's decision if the integrity of the federal judicial process is to be vindicated.

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[18] PSC order 5449a, Finding of Fact 41. (App. 35).

[19] Federal district courts lack jurisdiction to review state utility rate orders under the Johnson Act, 28 U.S.C. § 1342 (1988). (App. 187).

CONCLUSION

The Montana Supreme Court's decision is unsupported by any authority. This Court has never held that compensation which is due under the fourteenth amendment for the taking of private property for public use can be withheld on the basis of a state policy. In fact, the Court specifically held to the contrary in *First English.* The obstinate refusal of PSC and the Montana Supreme Court to afford Mountain Water Co. the protections guaranteed it under federal law will continue unless corrected by this Court. For the reasons stated above, Mountain Water Co. respectfully requests that the writ issue and that the decision of the Montana Supreme Court denying Mountain Water Co. compensation for its property taken under the statute be reversed.

RESPECTFULLY SUBMITTED this 12th day of November, 1992.

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MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff and Respondent,

v.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, Montana Public Service Commission, and Montana Consumer Counsel, Defendants and Appellants.

No. 91-446.

Supreme Court of Montana.

Submitted on Briefs May 7, 1992.

Decided July 21, 1992.

As Modified on Denial of Rehearing Aug. 13, 1992.

McDONOUGH, Justice.

Montana Department of Public Service Regulation, Montana Public Service Commission, and Montana Consumer Counsel appeal from an order of the First Judicial District, Lewis and Clark County, in favor of Mountain Water Company. We reverse.

We frame the following issue for appeal:

Whether the Public Service Commission's refusal to authorize recovery through prospective rate setting of past period § 69-4-511, MCA, expenses did not justly compensate Mountain Water Company, in violation of the Fifth and Fourteenth Amendments to the United States Constitution, and of Article II, Section 29 of the Montana Constitution?

In 1987, the Montana Legislature passed, and the Governor signed into law, Senate Bill No. 28. The law became effective on October 1, 1987, and was codified under § 69-4-511, MCA. The bill mandated that the private water service provider be responsible for the cost of maintaining water service pipelines from the main to the owner's property line. Under the statute, the property owner is responsible for the cost of the pipe and other supplies used in the service line. Prior to 1987, the property owner bore the entire cost of the pipe and of maintaining the line.

On October 1, 1987, the day the law went into effect, Mountain Water Company (MWC) filed a complaint against the Montana Public Service Commission (PSC) in United States District Court, seeking to have § 69-4-511, MCA, declared unconstitutional. The United States District Court held that § 69-4-511, MCA, was not unconstitutional. Specifically, it held § 69-4-511, MCA, did not constitute a prohibited taking.

On appeal, the Ninth Circuit held that the statute did not violate the Fifth Amendment and that any taking of MWC's private property by the statute is for a public use. Further, the court stated that MWC may seek just compensation for its property taken through rate setting before the PSC. *Mountain Water v. Montana Dept. of Public Serv. Reg.* (9th Cir.1990), 919 F.2d 593, 601.

On June 29, 1989, MWC filed an application with the PSC to increase its rates, in part to recover previous expenditures it had been compelled to provide for its customers under § 69-4-511, MCA. MWC proposed to capitalize § 69-4-511, MCA, expenses incurred between

January 1, 1988 and June 30, 1989. Recovery was sought through a two-year amortization. The PSC denied MWC recovery for the previous expenditures. However, with respect to ongoing § 69-4-511, MCA, expenses. MWC appealed the PSC's order. The District Court held that the PSC's refusal to allow recovery of back expenses incurred during 1988 and 1989 failed to justly compensate MWC for the taking. This appeal followed.

The issue before us is a question of law. In reviewing conclusions of law, our standard of review will be merely to determine if the District Court's interpretation of the law is correct. *Steer, Inc. v. Department of Revenue* (1990), 245 Mont. 470, 474, 803 P.2d 601, 603.

I

The Ninth Circuit held that § 69-4-511, MCA, expenses were a taking for public use requiring just compensation, which could be sought through rate-making. We must determine whether PSC's denial of recovery for previous expenditures denied MWC just compensation.

The PSC is an administrative agency charged, through powers granted by the Montana Legislature, with regulating public utilities pursuant to the provisions of §§ 69-3-101, MCA et seq. The rates set by the PSC through its rate-making rules must be at a level that allows a just compensation for any regulations imposed which impair the property interests of the utility company. *West Ohio Gas Co. v. Public Utilities Commission of Ohio* (1935), 294 U.S. 63, 55 S.Ct. 316, 79 L.Ed. 761. MWC argues that the PSC is bound by judicial estoppel. The PSC admitted during the course of the federal litigation

that § 69-4-511, MCA, was a taking and that MWC would be compensated through rate-making.

However, in making that admission the PSC did not waive application of the rules involved in rate-making. In Montana, public utility rates are set to match utility costs during the period that rates are in effect. The utility, the Montana Consumer Counsel, the PSC, or other persons with standing may seek a rate change when the financial information indicates a mismatch. See § 69-3-301, MCA et seq. MWC was aware that the Montana Legislature passed § 69-4-511, MCA. Prior to the law taking effect on October 1, 1987, MWC could have applied to the PSC to cover the utility costs for 1988 and 1989 under § 69-4-511, MCA.

The PSC argues that its refusal to authorize recovery in rates of prior period expenses is in line with public utility law and utility regulation in Montana. Rate-making is a legislative activity and is therefore prospective only in its effect. *State ex rel. Billings v. Billings Gas Co.* (1918), 55 Mont. 102, 110, 173 P. 799, 801; *Billings Utility Co. v. Public Service Commission* (1921), 62 Mont. 21, 33, 203 P. 366, 370. Historically, utility companies do not receive retroactive rate increases.

MWC cites *City of Helena v. Montana Dept. of PSR* (1981), 194 Mont. 173, 182-183, 634 P.2d 192, 198, as support for its position. We stated "It is clearly the law that utilities may not set their rates so as to amortize past deficits." *Galveston Elec. Co. v. Galveston* (1922), 258 U.S. 388, 395, 42 S.Ct. 351, 354, 66 L.Ed. 678, 683, was cited as the foundation for the rule. The city of Helena had sought to distinguish *Galveston* and its progeny because the cases

involved private utilities, not municipal utilities. We held that the PSC was not required to treat the two differently in considering past losses suffered even though in dicta we said a municipality's improvements can be funded differently. This rule against retroactive rate-making clearly applies to MWC, a private company.

The District Court agreed that "utilities may not set their rates so as to amortize past deficits" but held that a prohibition against allowing recovery of unanticipated expenses was not absolute. *Montana Consumer Counsel v. PSC and MPC* (1975), 168 Mont. 180, 541 P.2d 770. In *Montana Consumer Counsel* we upheld the PSC's decision authorizing Montana Power Company to increase its charges for natural gas services due to an increase in the costs of natural gas. However, the rate order in question encompassed present and prospective rate changes. *Montana Consumer Counsel* at 188, 541 P.2d at 774. The rate charges were not retroactive.

For the reasons set forth above, we conclude that the District Court erred in concluding MWC was not justly compensated by PSC's denial to retroactively allow recovery of § 69-4-511, MCA expenses.

We reverse.

HARRISON, HUNT, TRIEWEILER and GRAY, JJ., concur.

No. 91-446

IN THE SUPREME COURT OF THE
STATE OF MONTANA

1992

MOUNTAIN WATER COMPANY,
a Montana corporation,

Plaintiff and Respondent,

-vs-

(Filed
JUL 21 1992)

MONTANA DEPARTMENT OF
PUBLIC SERVICE REGULATION,
MONTANA PUBLIC SERVICE
COMMISSION, and MONTANA
CONSUMER COUNSEL,

Defendants and Appellants.

APPEAL FROM: District Court of the First Judicial District, In and for the County of Lewis and Clark, The Honorable Thomas C. Honzel, Judge presiding.

COUNSEL OF RECORD:

For Appellant:

Robin A. McHugh, Special Assistant Attorney General, Public Service Commission, Helena, Montana Mary Wright, Staff Attorney, Special Assistant Attorney General, Montana Consumer Counsel, Helena, Montana

For Respondent:

John Alke, Hughes, Kellner, sullivan [sic], and Alke, Helena, Montana

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Submitted on Briefs: May 7, 1992

Decided: July 21, 1992

Filed:

/s/ Ed Smith
Clerk

Justice R. C. McDonough delivered the Opinion of the Court.

Montana Department of Public Service Regulation, Montana Public Service Commission, and Montana Consumer Counsel appeal from an order of the First Judicial District, Lewis and Clark County, in favor of Mountain Water Company. We reverse.

We frame the following issue for appeal:

Whether the Public Service Commission's refusal to authorize recovery through prospective rate setting of past period § 69-4-511, MCA, expenses did not justly compensate Mountain Water Company, in violation of the Fifth and Fourteenth Amendments to the United States Constitution, and of Article II, Section 29 of the Montana Constitution?

In 1987, the Montana Legislature passed, and the Governor signed into law, Senate Bill No. 28. The law became effective on October 1, 1987, and was codified under § 69-4-511, MCA. The bill mandated that the private water service provider be responsible for the cost of maintaining water service pipelines from the main to the owner's property line. Under the statute, the property owner is responsible for the cost of the pipe and other

supplies used in the service line. Prior to 1987, the property owner bore the entire cost of the pipe and of maintaining the line.

On October 1, 1987, the day the law went into effect, Mountain Water Company (MWC) filed a complaint against the Montana Public Service Commission (PSC) in United States District Court, seeking to have § 69-4-511, MCA, declared unconstitutional. The United States District Court held that 69-4-511, MCA, was not unconstitutional. Specifically, it held § 69-4-511, MCA, did not constitute a prohibited taking.

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failed to justly compensate MWC for the taking. This appeal followed.

The issue before us is a question of law. In reviewing conclusions of law, our standard of review will be merely to determine if the District Court's interpretation of the law is correct. Steer, Inc. v. Department of Revenue (1990), 245 Mont. 470, 474, 803 P.2d 601, 603.

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However, in making that admission the PSC did not waive application of the policies involved in rate-making. In Montana, public utility rates are set to match utility

costs during the period that rates are in effect. The utility, the Montana Consumer Counsel, the PSC, or other persons with standing may seek a rate change when the financial information indicates a mismatch. See § 69-3-301, MCA et seq. MWC was aware that the Montana Legislature passed § 69-4-511, MCA. Prior to the law taking effect on October 1, 1987, MWC could have applied to the PSC to cover the utility costs for 1988 and 1989 under § 69-4-511, MCA.

The PSC argues that its refusal to authorize recovery in rates of prior period expenses is in line with public utility law and utility regulation in Montana. Rate-making is a legislative activity and is therefore prospective only in its effect. State ex rel. Billings v. Billings Gas Co. (1918), 55 Mont. 102, 110, 173 P. 799, 801; Billings Utility Co. v. Public Service Commission (1921), 62 Mont. 21, 33, 203 P. 366, ___. Historically, utility companies do not receive retroactive rate increases.

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The District Court agreed that "utilities may not set their rates so as to amortize past deficits" but held that a prohibition against allowing recovery of unanticipated expenses was not absolute. Montana Consumer Counsel v. PSC and MPC (1975), 168 Mont. 180, 541 P.2d 770. In *Montana Consumer Counsel* we upheld the PSC's decision authorizing Montana Power Company to increase its charges for natural gas services due to an increase in the cost of natural gas. However, the rate order in question encompassed present and prospective rate changes. *Montana Consumer Counsel* at 188, 541 P.2d at 774. The rate charges were not retroactive.

For the reasons set forth above, we conclude that the District Court erred in concluding MWC was not justly compensated by PSC's denial to retroactively allow recovery of § 69-4-511, MCA expenses.

We reverse.

/s/ R.C. McDonough
Justice

We Concur:

/s/ John Conway Harrison

/s/ William E. Hunt Sr.

/s/ Terry Trieweiler

/s/ Karla M. Gray
Justices

MONTANA FIRST JUDICIAL DISTRICT COURT
COUNTY OF LEWIS AND CLARK

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff/Petitioner, vs. MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION and MONTANA CONSUMER COUNSEL, Defendant/Respondents.	Cause No. CDV-90-607 ORDER ON PETITION FOR JUDICIAL REVIEW (Filed June 5, 1991)

This case is an appeal of two orders of the Montana Public Service Commission (PSC) which the Petitioner, Mountain Water Company, contends deny fully recovery of expenses incurred in complying with Section 69-4-511, MCA.

BACKGROUND

In 1987, Montana Legislature passed Senate Bill 28 (S.B. 28) which has been codified as Section 69-4-511, MCA. The statute requires privately-owned water companies such as Mountain Water to pay for maintenance of customer service lines running between the water main and the customer's property line. Previously the customer or property owner had that responsibility.

The statute became effective October 1, 1987. Prior to that time, the company unsuccessfully sought a stay from the PSC and also challenged the statute in federal district court on constitutional grounds. The federal district court granted summary judgment to the PSC, and the company appealed this ruling to the Court of Appeals for the Ninth Circuit. On November 26, 1990, the Ninth Circuit affirmed the decision of the lower court. *Mountain Water Co. v. Montana Dep't of Public Serv. Reg.*, 919 F.2d 593 (9th Cir. 1990).

On June 26, 1989, during the course of the litigation in federal court, the company filed an application with the PSC to increase water rates, in part to recover expenses incurred to comply with S.B. 28. The company proposed to capitalize S.B. 28 expenses incurred between January 1, 1988, and June 30, 1989, and to recover them through a two-year amortization. This proposal was denied by the Commission, which ruled that this would constitute prohibited retroactive ratemaking. With respect to ongoing S.B. 28 expenses, the Commission authorized the recovery through rates of $90,753 of annual S.B. 28 expenses.

STANDARD OF REVIEW

Under Section 69-3-402(1), MCA, a party in interest may commence an action in the district court to vacate and set aside a PSC order on the ground that it is unlawful or unreasonable. The burden of proof is on the party attacking or resisting the order to show that the order is either unlawful or unreasonable. Section 69-3-402(4), MCA.

Judicial review of PSC determinations is limited by Section 2-4-704(2), MCA, to matters of law, not fact. *Rozel Corp. v. Department of Public Service Reg.*, 226 Mont. 237, 243, 735 P.2d 282, 284 (1987). The Montana Supreme Court has stated,

> " 'We have repeatedly held that there will be no interference with the orders of the [PSC] unless:
>
> (1) they go beyond the power constitutionally given; or,
>
> (2) beyond their statutory power; or
>
> (3) they are based upon a mistake of law.
>
> However, questions of fact may be involved in determination of questions of law, so that an order, regular on its face, may be set aside if it appears:
>
> (1) that the rate is so low as to be confiscatory and in violation of the constitutional prohibition against taking property without due process of law; or
>
> (2) that the Commission acted so arbitrarily and unjustly as to fix rates contrary to evidence, or without evidence to support it, or
>
> (3) that the authority therein involved has been exercised in such an unreasonable manner as to cause it to be within the elementary rule that substance, and not shadow, determine the validity of the exercise of the power.' "

City of Helena v. Montana Dep't of Public Service, ___ Mont. ___, 634 P.2d 192, 197 (1981), quoting *Cascade County Consumers Ass'n v. Public Service Com'n.*, 144 Mont. 169, 192-93, 394 P.2d 856, 868, *cert. denied*, 380 U.S. 909 (1964).

DISCUSSION

The Ninth Circuit specifically held that the liability statute effects a taking of Mountain Water's private property for a public use. 919 F.2d at 599-600. Such a taking requires just compensation, which Mountain Water must seek through the Public Service Commission. *Id.* at 600. "Only if the PSC's rate order failed to compensate Mountain Water justly for all of its private property dedicated to public use can Mountain Water complain of a violation of its fifth amendment rights. Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order, but not the statute, unconstitutional." *Id.* (citations omitted). The issue thus becomes what constitutes just compensation.

The mere fact that Mountain Water has incurred additional expenditures under the liability statute does not in and of itself make the rate order unconstitutional. "[W]e note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's 'losses' under the liability statute are not constitutionally significant unless its set rates are 'unjust.' " *Id.* at 601. The problem here is that the PSC refused to consider these expenses for the initial eighteen-month period, reasoning that it was prohibited from considering these prior expenses because to do so would be retroactive ratemaking.

It is true that "utilities may not set their rates so as to amortize past deficits." *City of Helena v. Montana Dep't of Public Service*, ___ Mont. ___, 634 P.2d 192, 198 (1981),

citing *Galveston Elec. Co. v. Galveston*, 258 U.S. 388, 395 (1922). However, the prohibition against allowing recovery of unanticipated expenses is not absolute. The Montana Supreme Court has sustained the PSC in allowing municipal utilities to complete improvement projects which were deferred in order to make up unanticipated expenditures. "When the PSC grants sufficient funds to make up these projects, it is, in effect, making up past losses of the city under a controlled plan." *Id.* at ___, 634 P.2d at 198. Mountain Water is not a municipal utility and thus is not susceptible to the same reasoning as was used in *City of Helena* (i.e., that municipalities do not have profits to fall back on to make up unanticipated expenses), but the case clearly provides that there are some exceptions to the rule against retroactive recovery of past expenses. *See, also, Montana Consumer Counsel v. Public Service Commission*, 168 Mont. 180, 541 P.2d 770 (1975) (sustaining gas cost tracking adjustments during times of price fluctuations).

Mountain Water is entitled to just compensation for the taking of its property resulting from S.B. 28. For these costs in the future, the PSC included consideration of these expenses in its rate order and provided for a tracking mechanism. Finding of Fact No. 42, PSC Order No. 5449a. This is sufficient to provide just compensation. Just compensation does not require future dollar for dollar recovery of its costs.

For the costs incurred prior to the period encompassed by the rate order, however, the PSC did not consider the question of whether Mountain Water had received just compensation for these expenses. The PSC referred to Mr. Magone's affirmative response when

asked "if Mountain Water had recovered all its costs of doing business during the test year, as well as earn a return on its investment." Finding of Fact No. 43, PSC Order No. 5449a. Therefore, the PSC concluded, Mountain Water "did indeed, during the test year, recover costs incurred as a result of complying with SB 28." *Id.* Whether Mountain Water "recovered" these costs, however is not the issue. Rather, the issue is whether Mountain Water received just compensation for these expenses. Since the costs were never included in any rate consideration, clearly Mountain Water did not.

Both the PSC and the Montana Consumer Council [sic] argue that Mountain Water should have applied for a rate increase to cover these expenses before the statute took effect, as Butte Water Company did, and in that way could have recovered its costs prospectively. However, S.B. 28 imposed a new requirement, with an unknown price tag. As the PSC itself has noted, even after eighteen months of experience under the statute, the associated costs to the utility are volatile and subject to significant variation, beyond the utility's control. Finding of Fact No. 41, PSC Order No. 5449a. As the PSC acknowledges, ARM 38.5.106 requires that proforma adjustments be based on changes in costs that are known with certainty and which are measurable with reasonable accuracy at the time of filing. Findings of Fact Nos. 7-9, PSC Order No. 5449b. This Court finds it questionable how the costs of complying with S.B. 28 could have been considered to be known and measurable with reasonable accuracy *prior* to its implementation.

Because S.B. 28 constitutes a taking of private property for public use, Mountain Water is entitled to just

compensation. The PSC's refusal to allow recovery of $165,000 of these expenses incurred during 1988 and 1989 fails to justly compensate Mountain Water for this taking. Therefore an exception to the general prohibition against retroactive ratemaking is required, and the matter is remanded to the PSC for a decision in accordance with this Opinion and Order. Because the matter is resolved on the basis of just compensation, the Court does not address the merits of Mountain Water's arguments regarding judicial and collateral estoppel.

DATED this 5th day of June, 1991.

/s/ Thomas C. Honzel
District Court Judge

pc. John Alke
Robin A. McHough/PSC
Mary Wright/MTCC

Service Date: April 5, 1990

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * *

IN THE MATTER of the Application of MOUNTAIN WATER COMPANY for Authority to Increase Rates and Charges for Water Service in the Missoula, Montana Service Area.	)	UTILITY DIVISION
	)	DOCKET NO. 89.6.23
	)	ORDER NO. 5449a

FINAL ORDER

APPEARANCES

FOR THE APPLICANT:

John Alke, Attorney at Law, Hughes, Kellner, Sullivan & Alke, P.O. Box 1166, Helena, Montana 59624

FOR THE INTERVENORS:

Mary Wright, Staff Attorney, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59620

FOR THE COMMISSION:

Robin McHugh, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620

Ron Woods, Rate Analyst, 2701 Prospect Avenue, Helena, Montana 59620

BEFORE:

HOWARD L. ELLIS, Commissioner and Hearing Examiner
DANNY OBERT, Commissioner
WALLACE W. "WALLY" MERCER, Commissioner

BACKGROUND

1. On June 29, 1989 Mountain Water Company (Applicant, Company or MWC) filed an application with the Public Service Commission (Commission) for authority to increase water rates and charges for its Missoula, Montana, customers on a permanent basis by approximately 17.68 percent. If granted, this would constitute a revenue increase of approximately $804,241.

2. Concurrent with its filing for a permanent increase in rates MWC filed an application for an interim increase in rates of approximately 11.75 percent, equalling a revenue increase of approximately $534,329 or 66.4 percent of the proposed permanent increase.

3. The Montana Consumer Counsel (MCC) and the City of Missoula intervened in this proceeding. The MCC actively participated in all phases of this Docket.

4. On September 27, 1989 MWC and the MCC entered into a stipulation that, for purposes of this rate case, a reasonable cost of equity would be 12.5 percent and a reasonable hypothetical capital structure would be 55 percent equity and 45 percent debt. The stipulation also provided that the debt component of the capital structure would be divided into two parts, 25.5 percent

being the actual debt of the Company and 19.5 percent representing hypothetical debt.

5. The stipulation filed with the Commission contained a motion requesting that the Commission issue an order adopting the stipulation entered into by the Applicant and MCC. Before the Commission will accept a stipulation disposing of a contested issue in a rate case it requires, 1) that the parties to the stipulation provide sufficient information for the Commission to conclude that the stipulation is reasonable, and 2) that all parties have an opportunity to comment on the stipulation.

6. On November 27, 1989, following notice to all parties in this Docket, a meeting was held in the Commission offices to discuss the reasonableness of the proposed stipulation. Representatives of MWC and the MCC were present at the meeting. The purpose of the meeting was to allow the Applicant and the MCC to provide the Commission with additional background information in support of the reasonableness of their stipulation and to receive comments from all parties.

7. On December 22, 1989 the Commission, having considered the merits of the Applicant's interim rate application and information presented on the reasonableness of the proposed stipulation, issued Order No. 5449. This order granted the Applicant interim rate relief in the amount of $374,516 and adopted the proposed stipulation, for purposes of this Docket. Details of the Applicant's original proposal regarding capital structure and cost of equity as well as the stipulated proposal accepted by the Commission in Order No. 5449 will be discussed later in this order.

8. On January 30, 1990, following issuance of proper notice, a hearing was held in the City Council Chambers, City Hall, Missoula, Montana. For the convenience of the consuming public an evening session was held January 30, 1990, at 7:00 p.m. at the same location. The purpose of the public hearing was to consider the merits of the Applicant's proposed water rate adjustments.

9. The year ending December 31, 1988 is the test year in this application. The Commission finds this to be a reasonable period within which to measure the Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for water service.

FINDINGS OF FACT

10. At the public hearing, the Applicant presented the testimony and exhibits of:

Lee Magone, Vice President & General Manager, MWC
Don Cox, Certified Public Accountant.

11. The MCC presented the testimony of one expert witness, Frank Buckley, Rate Analyst, Montana Consumer Counsel. No public testimony was received during either of the hearing sessions scheduled for January 30, 1990.

CAPITAL STRUCTURE

12. In its application MWC proposed the following capital structure for rate case presentation:

Description	Amount	Ratio
Equity	$7,033,271	74.48%
Debt	2,410,000	25.52%
	$9,443,271	100.00%

13. As part of the stipulation entered into between the Applicant and the MCC, the Applicant agreed to the use of a hypothetical capital structure to determine its composite cost of total capital. The Applicant and MCC agreed to the use of a 45/55 debt-equity ratio, with the hypothetical debt being assigned a current cost of attracting debt for MWC, for purposes of calculating the following capital structure:

Description	Amount	Ratio
Equity	$5,188,299	55.00%
Debt 1	2,405,484	25.50%
Debt 2	1,839,488	19.50%
	$9,443,271	100.00%

14. The Commission, for the reasons stated in its Order No. 5449, found that use of the stipulated capital structure as presented in Finding of Fact No. 13 is reasonable in this case. The stipulated capital structure will be used to calculate the composite cost of total capital in this Docket.

COST OF EQUITY

15. The Applicant originally requested that the Commission authorize a 13.0 percent return on equity. As part of the stipulation between the Applicant and MCC, the Applicant agreed to reduce its requested return on equity from 13.0 percent to 12.5 percent.

16. The stipulated return on equity was not a contested issue during the public hearing in this Docket. As indicated by the Findings of Fact in Order No. 5449, the stipulated return on equity is within the range of the returns recently authorized by this Commission for other utilities under its jurisdiction. The 12.5 percent return on equity stipulated to by the Applicant and the MCC will be used in this order for purposes of determining MWC's composite cost of total capital.

COST OF DEBT

17. The actual debt capital (Debt 1) of the Applicant consists of a note issued by Park Water Company to Montana Power Company. This debt is an obligation of Park Water Company rather than it [sic] subsidiary, MWC, but the note has been properly assigned to the Applicant for ratemaking purposes.

18. The cost of debt, or interest, on this note is variable, the present cost being 9.25 percent and the cost at maturity being 10.0 percent. The cost of debt presented by the Applicant for this obligation was not challenged by any party participating in this proceeding and is accepted by the Commission.

19. The hypothetical debt (Debt 2) included in the Applicant's capital structure has been assigned a cost of 13.0 percent. This is the debt cost represented in the stipulation as MWC's current cost of attracting incremental debt. For the reasons discussed in Order No. 5449 the Commission, for purposes of this proceeding, has accepted this cost.

CAPITAL STRUCTURE AND COMPOSITE COST OF TOTAL CAPITAL

20. The Commission finds the following capital structure and composite cost of total capital to be reasonable:

Description	Amount	Ratio	Cost	Weighted Cost
Equity	$5,188,299	55.0%	12.50%	6.875%
Debt 1	2,405,484	25.5%	9.25%	2.359%
Debt 2	1,839,488	19.5%	13.00%	2.535%
	$8,984,414	100.0%		
Composite Cost of Total Capital				11.769%

FINDINGS OF FACT 12 THROUGH 20 ARE PRESENTED FOR INFORMATION PURPOSES ONLY. THE APPLICANT'S CAPITAL STRUCTURE AND COST OF CAPITAL WERE THE SUBJECT OF A SEPARATE COMMISSION ORDER.

RATE BASE

21. In its application MWC proposed an average original cost depreciated rate base of $9,375,318. In prefiled direct testimony MCC's expert witness proposed four adjustments reducing the Applicant's proposed rate base by a total of $199,710.

22. The Applicant's rebuttal testimony contested only one of the rate base adjustments proposed by the MCC. The Applicant contested MCC's proposal to exclude $55,766 from rate base. The contested amount

reflects the unamortized balance of service line expenses incurred by the Applicant in complying with Section 69-4-511, MCA.

23. For reasons that will be discussed fully in the operation and maintenance expense section of this order, the Commission finds that the Applicant's proposal to include in rate base the unamortized balance of service line expenses should be denied. The Commission further finds the Applicant's original cost depreciated rate base is $9,175,608.

OPERATING REVENUES

24. The Applicant in its Exhibit B proposed test period operating revenues of $4,549,484. The test period operating revenues as calculated by the Applicant were not a contested issue in this Docket and are accepted by the Commission.

OPERATING EXPENSES

25. The Applicant in Exhibit B, proposed total test period operation and maintenance expenses of $2,904,933. The test period operation and maintenance expense proposed by the Applicant includes proforma adjustments increasing expenses by $209,191. Only those items of expense that remain a contested issue will be addressed in this section.

26. MCC's expert witness proposed adjustments increasing and decreasing the Applicant's proforma expenses. The net effect of MCC's proposed adjustments was to decrease proforma expenses by a total of $196,665.

Those adjustments proposed by MCC that were not rebutted by MWC are assumed to be accepted. The unrebutted items result in reductions to proforma operation and maintenance expense totalling $75,166.

27. MWC in the rebuttal testimony of its witnesses (Exhibit Nos. C and D) framed the items of expense that were still in dispute between the parties. The testimony indicates the following expense items remain in dispute:

1) Senate Bill 28 compliance costs
2) Rate case expense
3) Administrative overhead costs
4) Water sampling costs
5) Ground water contamination study costs
6) Allocated salary of two main office employees.

28. The Montana Legislature passed Senate Bill No. 28 during its 1987 legislative session. SB 28 is codified as 69-4-511, MCA. For purposes of discussion in this order the term SB 28 will be used. SB 28 changed the responsibility for maintenance and repair of water service lines. Prior to October 1, 1987, the effective date of SB 28, the responsibility for repair and maintenance of the entire water service line from the water main to the premises of the consumer was the consumer's obligation. On October 1, 1987 it became the responsibility of the private water service provider to maintain and repair the portion of the water service line from the company's water main to the consumer's property line.

29. In testimony both MCC and MWC acknowledged that MWC had incurred expenses as a result of the legislated change in repair and maintenance responsibility. MCC and MWC disagree over the ratemaking

treatment that should be afforded costs incurred in complying with SB 28 during the period 1/1/88 through 6/30/89.

30. In its filing MWC has proposed that SB 28 costs incurred during an 18 month period prior to the filing of this rate application be capitalized and recovered through a two year amortization. Although the Applicant, in the rebuttal testimony of Mr. Magone, acknowledges that its proposal to recover the prior period SB 28 expenses represents a conflict with the general rule against retroactive ratemaking, the Applicant contends recovery should be allowed. The Applicant argues that the expense incurred in complying with the requirements of SB 28 represents a special circumstance that warrants departure from the Commission's general prohibition against retroactive ratemaking.

31. MCC opposes the Applicant's treatment and asserts that the Commission should not approve the Applicants's [sic] proposal to capitalize these costs and recover them over a two year amortization period. MCC alleges that allowing recovery of the service line maintenance expense incurred during the period 1/1/88 through 6/30/89 would represent retroactive ratemaking. MCC further contends that the $111,533 in costs incurred by the Applicant in complying with the provisions of SB 28 have already been recovered from its ratepayers.

32. MWC contends that special circumstances dictate that the Commission should allow recovery of the prior period expenses in prospective rates. These special circumstances, according to MWC, include the following: 1) The Commission represented in United States District

Court for the State of Montana, in litigation involving MWC and the Commission, that through the ratemaking process MWC would be compensated for money paid out to comply with SB 28 (Rebuttal Testimony of MWC witness E. Lee Magone, pp. 3-5, and MWC opening brief, pp. 3-4); and 2) The State of Montana imposed this cost on the Applicant and, therefore, it would be unfair and unreasonable for the Commission to deny recovery of the cost of discharging the statutory obligation based on the general prohibition against retroactive ratemaking (Rebuttal testimony of Mr. Magone, p. 5).

33. MWC, through the testimony of Mr. Magone and in its opening brief, argues that the Commission committed itself to granting MWC's proposal in the briefs that the Commission submitted to the United States District Court.[1] MWC quotes the following language from the Commission's Brief in Support of Defendant's Motion for Summary Judgment, pp. 12-13, filed January 29, 1988:

> There is no question that Mountain Water will incur certain operating expenses as a result of compliance with SB 28. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased. The PSC, for its part, will scrutinize all of Mountain Water's expenses to determine

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[1] MWC sought to have SB 28 declared unconstitutional in the United States District Court, Helena Division. As the enforcing agency the Commission defended the constitutionality of SB 28. Briefs were filed by both the Commission and MWC on simultaneous motions for summary judgment. On July 19, 1988 the Court granted the Commission's motion. That decision is presently on appeal.

> whether or not they are reasonable. Reasonable expenses will be added to a reasonable rate of return to arrive at the total amount of revenue (revenue requirement) that Mountain Water will be allowed to recover through rates.

MWC concludes from this language that, "The Commission specifically represented to the United States District Court that Mountain Water would be compensated for the money it paid out under Section 69-4-511, MCA, through the ratemaking process. . . . " Rebuttal Testimony of E. Lee Magone, pp. 3-5. Such a conclusion is unwarranted. The language quoted from the Commission's brief merely constitutes a statement of the standard ratemaking process. Standard ratemaking does not include the recovery of prior period expenses. Historic expense items, adjusted for known and measurable changes, form the basis for setting rates to recover expenses that will be incurred during the period rates will be in effect. Given the general rule against retroactive ratemaking, the Commission finds that the above language cannot reasonably be interpreted as a representation that past SB 28 expenses will be recovered. MWC has indicated it understands that rates are not normally set so as to ensure recovery of prior period, retroactive, expense. Therefore, MWC should understand that the above language carries no guarantee of the recovery of past expenses.

34. MWC also quotes from page 5 of the opinion of the District Court, dated July 19, 1988, that found SB 28 constitutional.

> The PSC may regulate public utilities through powers granted by the Montana legislature. Mont. Code Ann. § 69-3-101 *et. seq.* The

> rates set by the PSC through its rate-making policies must be at a level that allow a just compensation for any regulations imposed which impair the property interests of the utility company. *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U.S. 63 (1935). Compliance with the Act and the accompanying regulation will mean that MWC will incur additional operating expenses. These expenses will be a part of the data presented by MWC when applying to the PSC for additional rate increases.

The Commission is not clear why MWC refers to this language. In the Commission's opinion it is an accurate statement of the law and description of the ratemaking process. If MWC interprets this language as meaning that "just compensation for any regulations imposed which impair the property interests of the utility company" requires that the Commission allow recovery of prior period expenses, then such an interpretation is clearly in error. Just compensation in the utility ratemaking context means that rates must be set to allow the utility the ability to earn a reasonable return on the assets it devotes to utility service. If, in the opinion of the utility, due to increases in expenses (caused by government regulation or for any other reason), the utility cannot earn a reasonable return, it may apply to the Commission for rate relief. Upon a showing by the utility that it cannot earn a reasonable return the Commission will authorize rate relief. The rate relief authorized to the utility will be sufficient to recover costs that will be incurred during the period that rates will be in effect, as well as allowing the utility the opportunity to earn a reasonable return. To read into the Court's language an expectation by the

Court that the Commission would allow retroactive recovery of SB 28 expenses is, in the Commission's judgment, without merit.

35. On page four of its opening brief MWC quoted from the Commission's Reply Brief in Support of Defendant's Motion for Summary Judgment, p. 8, filed March 31, 1988:

> The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer no loss as a result of SB 28.

MWC then writes that its proposed ratemaking treatment for past SB 28 expenses "is in accordance with the Commission's representations to the federal court." First, the Commission finds that it did not represent by this language that it would apply a particular ratemaking treatment to SB 28 expenses upon the application of MWC. Second, MWC's proposal is not to treat recurring SB 28 expenditures as capital cost, rather than expense. MWC expressly characterizes expenditures incurred as a result of SB 28 as expense and says that, "The Company proposes to capitalize the expenses incurred during 1988 and the first six months of 1989, and amortize those expenses over a 2 year period." Prefiled Direct Testimony of MWC witness Don Cox, p. 10. This proposal is not the same as proposing to treat SB 28 expenditures as capital cost. The Commission here issues an order based on the proposal that MWC made, not on a proposal that it might have made.

36. MWC argues at various places in its opening brief, and in the rebuttal testimony of Mr. Magone, that fairness and equity, if not traditional rules of ratemaking, support the recovery of past SB 28 expenses. Mr. Magone states,

> It would be completely unfair and unreasonable for the State of Montana to impose upon Mountain Water the payment obligation specified in [SB 28,] then rely upon some general ratemaking concept to deny Mountain Water the recovery of its cost of discharging its obligations under the statute. . . . [B]asic concepts of equity and fair play [require the Commission] to craft an exception to the general rule against retroactive ratemaking. . . .

Rebuttal Testimony of MWC witness E. Lee Magone, p. 5.

37. Ensuring utility recovery of costs and the generation of authorized rates of return are management responsibilities. Unlike unregulated business, regulated utilities cannot adjust prices at will to compensate for increased costs and decreased return. To compensate for increased costs and decreased earnings regulated utilities must apply to regulatory commissions to increase rates. Regulatory commissions set rates based on general principles of ratemaking that have been determined by statutory and constitutional requirements as interpreted by the regulators and the courts. It is, primarily, the responsibility of utility managers to assess utility earnings and determine when to request a rate increase. It is further the responsibility of a utility to know how the regulatory system functions and to use that system to maximum advantage. MWC knew in March of 1987 that SB 28

would take effect on October 1, 1987; yet, for reasons unknown to the Commission, MWC waited until June 29, 1989 to apply for rate relief that specifically included SB 28 expenses as a component of its revenue requirement. By contrast, the Butte Water Company, Montana's other major private water utility, filed an application with the Commission on June 17, 1987, more than three months before the SB 28 effective date, that included a proposal for recovery of SB 28 expenses as a component of its rates. On February 22, 1988 the Butte Water Company, for both its Butte and Anaconda divisions, was authorized to file rates to reflect recovery of SB 28 expenses on a prospective basis. See Commission Order Nos. 5331 and 5332, Docket Nos. 87.6.30 and 87.6.31. The financial circumstances of MWC and Butte Water are different, and the Commission expresses no opinion on whether the ratemaking treatment for Butte Water SB 28 expenses would have been appropriate for MWC. The important point is that not until the summer of 1989 did the Commission have a proposal from MWC for treating SB 28 expenses as a component of its rates. And that proposal, if it were to be granted as filed, would force the Commission to violate a cardinal principle of ratemaking. If MWC had made a different proposal at an earlier time it may have substantially recovered the expenses incurred from compliance with SB 28 without running afoul of the prohibition against retroactive ratemaking. MWC had a choice, both as to the timing and the details of its proposal. MWC must live with the consequences of its choice. The Commission finds that under the circumstances MWC's appeals to equity and fairness are misplaced.

38. MWC's proposal to recover prior period expenses of $55,766, incurred as a result of compliance with SB 28 is denied. The reasons given by MWC to support its argument that the Commission should deviate from the rule against retroactive ratemaking are not persuasive.

39. At the hearing the Applicant requested that it be allowed to update it [sic] SB 28 expense to the level actually incurred during 1989. MWC indicated that recurring SB 28 expenses reflected in the filing totalled $74,355 but its 1989 experience was $90,753. Given the significant variation in the expense levels the Applicant felt it appropriate to request the updating of the information.

40. The Applicant's request to update this expense item was not contested by any party. The Commission finds that in this instance it is acceptable to update the expense. Based on the preceding Findings of Fact concerning SB 28 the Commission finds that the Applicant's proforma expenses should be reduced by $39,369.

41. MWC asserted that SB 28 expenses are not subject to the control of the utility and are expenses that are presently subject to significant variation. In support of this argument MWC drew the Commission's attention to the difference between the 1988 and 1989 expenses for this item. The Commission is persuaded by MWC that at the present time SB 28 expenses are volatile and not subject to the control of the utility.

42. Because of the volatility of the expense MWC proposed the implementation of a tracking mechanism for SB 28 expenses so that it could be assured that on a prospective basis it would be fully compensated for these

costs. The Commission agrees in principle with MWC's proposal to implement a tracker. At the present time, however, MWC has provided insufficient information to the Commission to authorize its implementation. The Commission finds that the Applicant should make a tariff filing to be approved by the Commission, detailing its proposed tracking mechanism. This tariff filing, to be consistent with others authorized by the Commission, should not recognize a time value of money.

43. Mr. Magone in his testimony implies that MWC did not recover through its test year rates the costs of discharging its obligation to comply with the requirements of SB 28. This statement is not supported by the facts in this case. When asked if MWC recovered all its costs of doing business during the test year, as well as earn a return on its investment, Mr. Magone replied affirmatively. Since all costs of doing business were recovered and a return on investment was earned, MWC did indeed, during the test year, recover costs incurred as a result of complying with SB 28.

44. Rate case expense was another of the disputed matters between the parties in this Docket. The Applicant proposed to recover in rates over a two year period $100,980 in projected rate case expenses. The Applicant based its estimate on actual rate case expense incurred in preparing and presenting its 1986 general rate application to the Commission.

45. MCC's witness made a data request to the Applicant on the actual year-to-date rate case expense for this presentation. The Applicant responded that as of September, 1989 MWC had incurred $25,224 in rate case

expense. Based on this response, recognizing that the Applicant would incur additional costs before the completion of this rate case, the MCC's witness recommended a rate case expense of $50,000 to be amortized over two years.

46. During cross-examination MWC witness Don Cox was asked if he could provide an updated actual rate case expense for MWC. Mr. Cox stated that as of the end of December, 1989 MWC had incurred $37,491.17 in costs for preparing and presenting this rate application. Mr. Cox was also asked if, in his opinion, the expense for conducting this case would be as great as that incurred by MWC for it [sic] 1986 presentation. Mr. Cox responded that, barring prolonged litigation, he would guess that it would not be as expensive.

47. The Commission is not comfortable accepting either of the cost estimates presented for this item of expense. The MCC's estimate appears to understate the costs that will be incurred by the Applicant, and MWC's estimate appears to overstate the costs.

48. As of December, 1989 MWC had incurred actual rate case costs in excess of $37,000. This cost was prior to MWC's preparation for the public hearing, participation in the public hearing, and briefing of issues in this Docket. All of these represent significant costs factors relative to the rate case presentation; therefore, in all probability rate case expense will exceed $50,000.

49. MCC has elicited from the Applicant an admission that costs for preparing this rate case are lagging behind the costs incurred in preparing the 1986 rate case.

This lends support to MCC's position that the costs to be recovered should be reduced.

50. Since neither party's estimate is clearly correct the Commission is placed in the position of having to make a subjective determination regarding the appropriate expense allowance. The Commission finds that a reasonable expense recovery for this item of expense is $75,000.

51. To reflect the adjusted rate case expense the Commission finds that the Applicant's proforma expenses should be reduced by $12,990 annually.

52. In his prefiled testimony Frank Buckley, the MCC's expert witness, proposed that the Applicant's payroll expense be reduced by $260. Mr. Buckley stated that increases in general and administrative salary levels warranted the transfer of additional payroll expense to Construction Work In Progress (CWIP).

53. In his rebuttal testimony Mr. Cox stated that MWC's costs transferred to CWIP for administrative overhead are not contingent upon the salary levels of employees. Mr. Cox indicated that the amount of MWC administrative overhead transferred to CWIP was dependent on capital costs incurred and equalled 5 percent of the construction costs. He further stated that changes in payroll costs for general and administrative would have no affect on the amounts transferred to CWIP. Based on the testimony the Commission finds that the Applicant's payroll expense should not be reduced by $260 as proposed by MCC.

54. No controversy surrounded the permissibility of MWC recovering costs incurred for water sampling or a ground water contamination study. The dispute surrounding these issues centered on the appropriate amount to be recovered. The Applicant proposed to recover $19,200 and $17,920 for water sampling expense and the ground water contamination study, respectively.

55. MCC disagreed with the amounts proposed by the Applicant. MCC, utilizing an annualization, determined that the Applicant should be authorized $14,460 for water sampling costs and $8,960 for the ground water contamination study.

56. At the hearing MWC cross-examined Mr. Buckley regarding his proposed adjustments to these items of expense. During this cross-examination the Applicant elicited a concession from Mr. Buckley that he would have no objection to MWC recovering the 1989 actual level of expenditure for these two items of expense.

57. The Commission finds that the Applicant should be allowed to recover $14,020 for the ground water contamination study and $18,313 in water sampling costs. The amounts accepted by the Commission represent a decrease from the amounts originally proposed by the Applicant. MWC's proforma expenses should be decreased by $2,837 annually.

58. The last contested operating expense is the Applicant's proposal to recover an allocated portion of salaries and fringe benefits for two of Park Water Company's employees. Park Water Company is the parent of MWC and provides certain support services to MWC through its main office in Downey, California. MCC

asserts that the aliquot portion of salaries and fringe benefits for Park Water Company's Vice President – Investments and Acquisitions and Vice President – Policy, Planning and Rates, should not be recoverable from MWC ratepayers. Mr. Buckley, in his prefiled testimony stated that in his opinion these two positions " . . . have little, if anything, to do with or for Mountain Water Company."

59. MWC witness Mr. Magone, in his prefiled rebuttal testimony, opposed Mr. Buckley's view and indicated that these two positions did indeed provide tangible services to MWC. In his testimony Mr. Magone made the following statements regarding the Vice President – Policy, Planning and Rates, prior to his retirement:

> [A]mong other things, he was in charge of the Company's regulatory affairs, particularly the preparation and presentation of rate cases. Mr. Gallup was in charge of Mountain Water Company's preparation and presentation of its last case to this Commission, PSC Docket No. 86.9.51 . . .
>
> Mr. Gallup decided to retire in 1987 . . . Mr. Gallup agreed to work part-time in 1988 in order to insure a smooth transition. As a result, the Company's 1988 test year cost of service includes the salary and fringe benefits paid Mr. Gallup in 1988. Those expenses are properly allocable to Mountain Water under the four factor allocation.

(Rebuttal Testimony of MWC witness E. Lee Magone, p. 11.)

60. In support of his contention that salary and fringe benefits of the Vice President – Investments and Acquisitions was properly recoverable from MWC ratepayers Mr. Magone stated the following at pages 12 and 13 of his prefiled rebuttal testimony.

> That exhibit clearly establishes the services that the position provides to Mountain Water Company. In addition to the general corporate duties, that position, which is held by Mr. Don Trevitt, is responsible for the management of the cash funds of Park Water Company and its subsidiaries, and the procurement of debt capital. The individual subsidiaries of Park Water Company, including Mountain Water, do not have their own finance and treasury departments. These functions are instead performed by Park Water Company on a centralized basis. Mountain Water, as does the other subsidiaries, forwards its cash balances to Park Water Company, which then manages the money and returns it to the subsidiaries when it is needed.
>
> Mr. Buckley apparently believes, on the basis of the Company's response to PSC data request 7, that the procurement of debt capital by Mr. Trevitt provides no benefits to the Mountain Water Company, because no debt capital was actually issued in the name of Mountain Water during the test period. That theory is directly contradicted by this Commission's decision in Order No. 5449 entered in this docket on December 22, 1989. Specifically, the Commission found in Finding of Fact 8 of the Order:
>
> > Mountain Water Company is a wholly owned subsidiary of Park Water Company (Park Water). Park Water provides certain

> support service to MWC through its main office in Downey, California. One of the services provided to MWC, by Park Water, is financial management assistance. The main office financial management assistance includes the handling of any potential debt placement for Mountain and all other subsidiaries under Park's corporate umbrella.
>
> Based upon that finding, the Commission held that in future rate cases the cost of hypothetical debt in a hypothetical capital structure for Mountain Water will be reflected at the cost of debt capital to the Park Water Company. It would be completely unreasonable and unfair for this Commission to capture in Mountain Water's rates the favorable cost of debt that Park Water Company can obtain, then turn around and contend that the individual who obtains that favorable cost of debt for Park Water Company provides no useful services to Mountain Water.

61. Mr. Magone, on cross-examination, was asked questions regarding specific tasks and services performed by these two positions during the 1988 test year that provided benefit to MWC. Mr. Magone indicated that Mr. Gallup, who retired, came back essentially to work on rate cases filed by the parent and its subsidiaries. The following exchange between MCC and Mr. Magone took place during cross-examination regarding the Vice President – Policy and Planning position.

> Q. Well, I understand that he was working for the Park Water Company. What I'm interested in is specific tasks that he performed or services that he provided to the Mountain Water Company during 1988?

A. I'm not really aware of them by name. I'm just not sure what he did.

Q. Did you have any contact directly with Mr. Gallup during 1988?

A. Perhaps, I don't recall.

Q. You don't recall whether you asked him to perform any services or do any work specifically for the Mountain Water Company?

A. No, ma'am, I do not.

Q. Did you review any work products of Mr. Gallup produced during 1988?

A. I don't think so.

62. Mr. Magone's answers are contrary to his assertion that it is appropriate to recover 23.75 percent of this position's salary from MWC ratepayers. Mr. Magone states in his rebuttal testimony and on cross-examination that the primary job duties of this position are rate case related. But in the preceding exchange he cannot specifically recall reviewing any work products from the position, requesting the person holding the position to perform any services or work for MWC, or having any direct contact with the person holding the position. The Applicant was unable to show that this position, which is mainly rate case related, performed any beneficial functions for MWC during the test year. The Commission finds the Applicant's request to recover salary and fringes should be denied.

63. In regard to the Vice President – Investments and Acquisitions, Mr. Magone testified in prefiled rebuttal, and on cross-examination, that this individual did, in his opinion, provide services that directly benefited

MWC. Mr. Magone testified that of eleven duties and responsibilities described in this position's job description, he could identify two that specifically benefited MWC; he indicated he had no specific knowledge of the remaining nine. The duties and responsibilities he identified as benefiting MWC were cash management duties and debt capital procurement.

64. Mr. Magone asserts that the debt capital procurement responsibility of this position produces a tangible benefit to MWC and its subscribers. He indicated that on a prospective basis the Commission intends to use the lower cost debt available to Park Water, to determine MWC's cost of hypothetical debt. He argued that it would be unreasonable for the Commission to capture in MWC's rates the favorable cost of debt obtainable by Park Water, then turn around and disallow recovery of the allocated salary of the Park Water employee that obtains the debt because he provides no useful service to MWC.

65. In this Docket this argument has no merit. In determining the hypothetical cost of incremental debt for MWC, the Commission did not substitute the more favorable cost of debt obtainable by Park Water. Instead of substituting the more favorable rate, the Commission accepted the stipulated cost determined reasonable by MWC and MCC. This stipulated cost of debt assumed that MWC would be the entity obtaining the debt not the corporate parent; therefore, the cost of incremental debt determined for MWC reflects the cost at which MWC could attract debt, not the parent.

66. The cost of debt capital awarded MWC in this proceeding does not, as the Applicant represents, support

the Applicant's contention that the salary and fringes of the Vice President – Investment and Acquisitions should be recoverable from MWC ratepayers.

67. On cross-examination by the PSC staff, Mr. Magone explained that MWC generated excess cash during certain periods when revenues exceeded expenses. He further explained MWC's excess cash is sent to the corporate office for investment. The management of the monies sent to corporate and invested by corporate are the responsibility of this position.

68. On cross-examination by MCC, Mr. Magone was asked if excess cash invested yielded income either through interest earnings or dividends. Mr. Magone indicated that he hoped so. When asked if income from interest earnings or dividends generated by investment of MWC excess cash was reported and considered as a regulatory revenue, he indicated he did not know.

69. In response to questions during the hearing, Mr. Magone stated that he presumed part of the excess cash available for investment by MWC was provided by ratepayers. He further indicated, that in his opinion, since part of the excess cash is provided by the ratepayers it would be appropriate that part of the interest earnings be reflected as benefiting the ratepayers.

70. Generally, for purposes of establishing rates, interest or dividends earned on short-term investments, such as investment of excess cash, is not reflected as regulatory revenue. The same treatment is afforded interest expense incurred on short-term borrowings, it is not

reflected as a regulatory expense. From a regulatory perspective management of short-term investments or borrowings are not a consideration in ratemaking. The expense or revenue is presented below the line for ratemaking purposes, i.e., it does not impact the regulatory operating statement. Therefore, arguing that salary and fringes should be recoverable from ratepayers for performance of this function is not valid. For all the Commission knows, earnings on short-term investments could totally offset the salary and fringe requirements of this position for performance of this function.

71. Of the 11 job duties and responsibilities outlined in the job description for this position the Applicant could not identify any functions performed that represent a tangible benefit to MWC ratepayers.

72. The Commission finds that the Applicant should be denied recovery of the salary and fringe benefit costs for the positions of Vice President – Policy, Planning and Rates and Vice President – Investments and Acquisitions. MWC's proforma expenses should be decreased by $30,942 to reflect this disallowance.

73. Based on the preceding Findings of Fact proforma operation and maintenance expenses are found to be $2,743,629, recognizing total proforma adjustments increasing expenses by $47,886.

DEPRECIATION EXPENSE

74. The test period depreciation expense is not a contested issue in this Docket. The Applicant proposed

depreciation expense of $396,016, which is accepted by the Commission.

TAXES OTHER THAN INCOME

75. The Applicant proposed an expense for Taxes Other Than Income at present rates of $324,028. The MCC's witness proposed adjustments decreasing this category of expense by $5,901. The adjustments proposed by MCC's witness were not contested by the Applicant. The Commission finds Taxes Other Than Income to be $318,127.

REVENUE REQUIREMENT

76. Based on the Findings of Fact contained herein, the Commission finds that in order to produce a rate of return of 11.769 percent on MWC's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of $414,727 from its Missoula, Montana water utility.

77. Applicant's accepted test year proforma operating revenues, expenses and rate of return are summarized as follows:

MOUNTAIN WATER CO

Computation of Ne

	Present Rates (Company)	Adj
Operating Revenues	$4,549,484	
Deductions:		
O&M Expense	$2,904,933	
Depreciation	396,016	
Taxes Other Than Income	324,028	
Income Taxes	285,295	
Net Income	$639,212	
Rate Base	$9,375,318	
Return on Rate Base	6.82%	

(1) Applicant's bad debt expense is a funct

COMPANY - MISSOULA DIVISION

Net Income - Test Year 1988

Adjustment	Test Year	To Produce 11.769% Rate of Return	Accepted by the Commission
	$4,549,484	$414,727	$4,964,211
(161,304)	$2,743,629	$2,939 (1)	$2,746,568
	396,016		396,016
(5,901)	318,127	1,120	319,247
(9,640)	275,655	146,848	422,503
	$816,057		$1,079,877
(199,710)	$9,175,608		$9,175,608
	8.89%		11.769

nction of revenues

RATE DESIGN

78. The Applicant's proposed rate design was not challenged by any party participating in this proceeding. The Commission's examination of the rate structure indicates that the Applicant has attempted to equitably distribute the cost of providing service to the various customer classifications and it is, therefore, accepted.

MISCELLANEOUS

79. In his prefiled testimony Mr. Buckley discusses what the Commission perceives to be a significant shortcoming in MWC rate presentations. Park Water, the parent company, does not directly assign many identifiable costs to the cost-causing division. Rather than assign costs directly, the parent relies, for the most part, on the four-factor allocation procedure, developed by the California Public Utilities Commission (CPUC), for recovery of main office common costs.

80. In this Commission's opinion Park Water is not following the directions provided in the four-factor allocation procedure accepted by the California Commission. The "Policy Statement on 4-Factor Method," prepared by the CPUC and provided the Commission staff during an audit, provides in part as follows:

> Administrative and general expenses consist of both direct and indirect items of expense. *The items applicable to specific operations are first segregated and assigned directly to operations. It is especially important that effective measures be taken to assure that as many of these expenses as possible are assigned directly.* The maintenance of time

> records is recommended as a basis for the direct assignment of salaries and related expenses of these employees who are engaged in work on more than one operation. (emphasis added).

81. In light of this Park Water's response to PSC data request 6 clearly shows that the company is not following the directions for proper utilization of the four-factor allocation. The failure to directly assign as many costs as possible poses a credible basis for challenging the appropriateness of the costs determined by Park Water through their application of the allocation procedure.

82. MWC/Park Water should in future rate cases before this Commission be prepared to show that it is directly assigning all costs possible to the cost-causing division. Continued use of the allocation procedure without assigning as many costs as possible directly could result in the Commission not accepting the allocation procedure.

83. In order to avoid any potential future conflicts regarding the appropriateness of the Company's allocation procedure the Company should commence a dialogue with the staff of the MCC and the Commission. This dialogue should be directed toward developing an allocation procedure that satisfies the Commission's concerns in this matter.

CONCLUSIONS OF LAW

1. The Applicant, Mountain Water Company, is a public utility as defined in Section 69-3-101, MCA. The Montana Public Service Commission properly exercises

jurisdiction over Applicant's rates and service pursuant to Section 69-3-102, MCA.

2. The Commission has provided adequate public notice and an opportunity to be heard as required by Section 69-3-303, MCA, and Title 2, Chapter 4, MCA.

3. The rates and rate structure approved in this order are just and reasonable. Sections 69-3-201, and 69-3-330, MCA.

ORDER

NOW, THEREFORE, IT IS ORDERED THAT:

1. Mountain Water Company shall file rate schedules which reflect an increase in annual revenues of $414,727 for its Missoula, Montana service areas. The increased revenues shall be generated by increasing rates and charges to all customer classifications as provided herein.

2. This rate increase is in lieu of and not in addition to the rate increase approved in Order No. 5449.

3. The rates approved herein shall not become effective until approved by the Commission.

4. The Commission authorizes Mountain Water Company to file a tariff detailing its proposed tracking mechanism for SB 28 expenses.

DONE IN OPEN SESSION at Helena, Montana, this 3rd day of April, 1990, by a vote of 3 – 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

/s/ Howard L. Ellis
HOWARD L. ELLIS, Vice Chairman

/s/ Wallace W. "Wally" Mercer
WALLACE W. "WALLY" MERCER, Commissioner

/s/ Danny Oberg
DANNY OBERG, Commissioner

ATTEST:

/s/ Ann Peck
Ann Peck
Commission Secretary

(SEAL)

NOTE: Any interested party may request that the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. *See* ARM 38.2.4806.

MONTANA PUBLIC SERVICE COMMISSION

CERTIFICATE OF SERVICE

* * *

I hereby certify that a copy of FINAL ORDER NO. 5449a in DOCKET NO. 89.6.23, in the matter of MOUNTAIN WATER COMPANY's Application For Authority To Increase Rates and Charges For Water Service In Its Missoula, Montana Service Area, dated April 3, 1990, has today been served on all parties listed below by mailing a

copy thereof to each party by first class mail, postage prepaid.

Date: April 5, 1990

/s/ Joyce Baumberger
For The Commission

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Service Date: June 29, 1990

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * *

IN THE MATTER of the Application of MOUNTAIN WATER COMPANY for Authority to Increase Rates and Charges for Water Service in the Missoula, Montana Service Area.	))))))	UTILITY DIVISION DOCKET NO. 89.6.23 ORDER NO. 5449b

ORDER ON MOTION FOR RECONSIDERATION

BACKGROUND

1. On April 5, 1990 the Montana Public Service Commission (Commission) issued Order No. 5449a disposing of all matters then pending in this Docket. On May 8, 1990, the Applicant, Mountain Water Company (MWC) filed a Motion for Reconsideration on the issue of the Commission's treatment of prior period expenses incurred in the discharge of its obligations under Section 69-4-511, MCA (designated "SB 28" hereafter, and in Final Order No. 5449a).

2. At a June 8, 1990, work session scheduled at the regularly held agenda on June 4, 1990, the Commission considered the issue and found no reason to modify its Order No. 5449a except to the extent of making technical corrections and clarifying certain of the Findings of Fact.

3. On page 2 of its motion MWC states that the Commission's Finding of Fact Nos. 28 and 29 seem to

indicate that MWC is responsible for the actual maintenance and repair of its customer service lines. The Commission agrees that those findings can be construed as placing an actual maintenance and repair responsibility on MWC for service lines. SB 28 does not impose the actual repair and maintenance responsibility on MWC; it imposes only a financial obligation for service line repairs occurring between the company's water main and the customer's property line. Finding of Fact Nos. 28 and 29 should read as follows:

> The Montana Legislature passed Senate Bill No. 28 during its 1987 legislative session. SB 28 is codified as 69-4-511, MCA. For purposes of discussion in this order the term SB 28 will be used. SB 28 changed the responsibility for the cost of maintenance and repair of water service lines. Prior to October 1, 1987, the effective date of SB 28, the responsibility for the cost of repair and maintenance of the entire water service line from the water main to the premises of the consumer was the consumer's obligation. On October 1, 1987 it became the responsibility of the private water service provider to pay for a portion of the maintenance and repair of the water service line from the company's water main to the consumer's property line.
>
> In testimony both MCC and MWC acknowledged that MWC had incurred expenses as a result of the legislated change in responsibility for the cost of service line repair and maintenance. MCC and MWC disagree over the ratemaking treatment that should be afforded costs incurred in complying with SB 28 during the period 1/1/88 through 6/30/89.

4. At pages 2 and 3 of its motion the Applicant requests a technical correction regarding the amount of SB 28 expense recovery under consideration in this Docket. In Order No. 5449a the Commission indicated that the Applicant is requesting recovery of costs totalling $111,533 in costs incurred during the period January 1, 1988 through June 30, 1989, for compliance with SB 28. Since a two year amortization of this cost was proposed by the Applicant the Commission further indicated that it was considering $55,766 as a component of the current cost of service.

5. At the public hearing the Applicant requested that it be allowed to update costs associated with its compliance with SB 28. *See* TR pp. 40-41. The Applicant requested that it be allowed to recover costs totalling $165,108 incurred during the period January 1, 1988 through December 31, 1989. Amortizing this cost over a two year period, as proposed by the Applicant, would result in $82,544 being a component of the current cost of service.

6. No objections were made to the Applicant's proposal to update costs incurred in complying with the requirements of SB 28. Therefore the Commission, in Order No. 5449a, should have used the revised costs and hereby makes the technical correction requested by the Applicant to amend Order No. 5449a to incorporate the corrected costs.

7. At pages 3 and 4 of its Motion for Reconsideration the Applicant represents that Commission rule ARM 38.5.106 precluded MWC from filing a rate application incorporating SB 28 compliance costs, as a component of

its cost of service, at any time earlier than the date of filing in this docket. MWC further represents that *historic* cost data regarding SB 28 compliance costs was the only satisfactory method of supporting SB 28 expenses as a component of its cost of service, given the requirements of ARM 38.5.106. MWC's representations of the requirements imposed on a utility by this rule is incorrect and is inconsistent with the Commission's interpretation and application of this rule.

8. ARM 38.5.106 provides a three part test for proforma adjustments to be accepted as a component of a utility's overall cost of operation. The three parts of the test that must be satisfied are 1) the adjustment must be based on changes in costs that are known with certainty, 2) the adjustment must be based on changes in costs which are measurable with reasonable accuracy at the time of filing, and 3) the expense must become effective within 12 months of the close of a historic test year. SB 28 compliance costs could have been presented by the Applicant as a proforma adjustment to a test year and met all three parts of this test using a 1986 test year and not a 1988 test year as represented by the Applicant in its motion.

9. The Commission refers the Applicant to Butte Water Company, Commission Docket No. 87.6.30, Order No. 5331. In the Butte Water docket the Commission was presented with a proposal, that was approved, to incorporate SB 28 compliance costs as a proforma adjustment to the company's overall cost of service. In that proceeding Butte Water utilized a 1986 test year and made a satisfactory showing to the Commission that the SB 28

proforma adjustment represented a known and measurable change occurring within 12 months of the close of the test year.

10. On page 4 of its motion the Applicant states:

> The Commission seems to suggest in its Finding of Fact 43 that Mountain Water has recovered the costs incurred in 1988 and 1989 in complying with SB 28. The Commission has no basis for making such a suggestion. It cannot seriously contend that the rates in effect during 1988 and 1989 were based upon a cost of service which included Mountain Water's cost of complying with SB 28. The rates in effect during those two years were established in PSC Docket No. 86.9.51 and were based upon a cost of service derived from an historic year ended December 31, 1985. Both the test year and the cost of service derived from that test year predate the effective date of SB 28 by almost two years. . . . The Commission's final order in this docket has determined that the rates Mountain Water was permitted to charge its customers in 1988 failed to recover its cost of service as established by this Commission by $414,727. Part of the shortfall was because of the costs incurred by Mountain Water in complying with the provisions of SB 28.

The Commission does not suggest, it states, in Finding of Fact No. 43, that MWC recovered it 1988 and 1989 SB 28 compliance costs. Mr. Magone stated that MWC recovered all of its costs of doing business during the test year and also earned a return on its investment. This means that the SB 28 compliance costs were recovered because

SB 28 costs were one of MWC's costs of doing business during the test year.

11. In the passage quoted above, MWC mischaracterizes the ratemaking process by asserting that it was impossibile [sic] for MWC to have recovered SB 28 costs because the Commission had not specifically considered those costs as part of the MWC cost of service in a previous docket. MWC portrays the ratemaking process as a mechanism that isolates individual financial items, in this case SB 28 expenses, as the source of an earnings shortfall. Individual adjustments to financial statements are examined separately in the ratemaking process but it is not those adjustments standing alone that determine the need for rate relief. The ratemaking process examines the financial statements of a filing utility in their totality. Without considering all financial information impacting the revenue requirement of the utility no determination of a need for rate relief can be rendered.

12. The Motion for Reconsideration, at page 8, discusses the possibility that SB 28 expenses may be capital in nature rather than operating. On page 8 the Applicant suggests that if the Commission is of the opinion that SB 28 expenses are capital in nature then the Commission in its order on reconsideration should direct the Applicant to capitalize the costs and apply ordinary depreciation rates to the amounts capitalized. Nowhere on the record in this Docket is there testimony or exhibits indicating that SB 28 costs are capital in nature. If the Applicant wishes the Commission to consider treating the prior period SB 28 costs as capital costs then it will have to make a request that the docket be reopened for the taking of additional testimony on this issue. The Applicant is

cautioned, however, that if the Docket is reopened for the taking of additional evidence on the capital nature of the prior period SB 28 expenses, treatment afforded current and prospective SB 28 expenses would have to be considered also.

13. Beginning on page 5 of its Motion for Reconsideration MWC asserts that the Commission, based on representations it made to the United States District Court in the course of defending SB 28 from a constitutional challenge, is bound to approve MWC's proposal for the ratemaking treatment of prior period SB 28 expenses. The Commission has already responded to this assertion in Final Order No. 5449a, and simply repeats that MWC, once again, distorts the Commission's argument to the District Court and mischaracterizes the basis for the Court's decision. The Commission finds that its decision in this case is entirely consistent with its position in all phases of the SB 28 litigation.

14. On page 9 of its Motion for Reconsideration MWC argues that the Commission's decision on SB 28 expenses in Final Order No. 5449a constitutes an unconstitutional taking of the private property of MWC. The Commission finds that this argument indicates a misunderstanding on the part of MWC about the nature of public utility ratemaking. The rates approved as a result of Final Order No. 5449a will allow MWC the opportunity to earn a reasonable return on its investment in utility service. Therefore, Final Order No. 5449a does not constitute an unconstitutional taking of MWC's property.

CONCLUSIONS OF LAW

1. The Applicant, Mountain Water Company, is a public utility as defined in Section 69-3-101, MCA. The Montana Public Service Commission properly exercises jurisdiction over Applicant's rates and service pursuant to Section 69-3-102, MCA.

2. The Commission has provided adequate public notice and an opportunity to be heard as required by Section 69-3-303, MCA, and Title 2, Chapter 4, MCA.

3. The rates and rate structure approved in this order are just and reasonable. Sections 69-3-201 and 69-3-330, MCA.

ORDER

With respect to the modifications to Order No. 5449a described and discussed at paragraphs 3-6 of this Order, Mountain Water Company's Motion for Reconsideration is Granted. In all other respects Mountain Water company's Motion for Reconsideration of Order No. 5449a is Denied.

Done and Dated this 26th day of June, 1990 by a vote of 3-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

/s/ Howard L. Ellis
HOWARD L. ELLIS, Vice Chairman

/s/ Wallace W. "Wally" Mercer
WALLACE W. "WALLY" MERCER, Commissioner

/s/ Danny Oberg
DANNY OBERG, Commissioner

ATTEST:

/s/ Ann Peck
Ann Peck
Commission Secretary

(SEAL)

NOTE: You may be entitled to judicial review in this matter. Judicial review may be obtained by filing a petition for review within thirty (30) days of the service of this order. Section 2-4-702, MCA.

MONTANA PUBLIC SERVICE COMMISSION

CERTIFICATE OF SERVICE

* * *

I hereby certify that a copy of ORDER NO. 5449b in DOCKET NO. 89.6.23, in the matter of MOUNTAIN WATER COMPANY's Application For Authority To Increase Rates and Charges For Water Service In Its Missoula, Montana Service Area, dated June 26, 1990, has today been served on all parties listed below by mailing a copy thereof to each party by first class mail, postage prepaid.

Date: June 29, 1990

/s/ Tina M. Shorten
For The Commission

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MOUNTAIN WATER COMPANY, *Plaintiff-Appellant,* v. MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION; MONTANA PUBLIC SERVICE COMMISSION, *Defendants-Appellees.*	No. 88-4097 D.C. No. CV-87-92-CCL OPINION

Appeal from the United States District Court
for the District of Montana
Charles C. Lovell, District Judge, Presiding

Argued and Submitted October 5, 1989
Submission Deferred February 21, 1990
Resubmitted March 26, 1990
San Francisco, California

Filed November 26, 1990

Before: Thomas Tang, Cynthia Holcomb Hall and Melvin Brunetti, Circuit Judges.

Opinion by Judge Tang

OPINION

TANG, Circuit Judge:

Mountain Water Company ("Mountain Water") appeals summary judgment for the Montana Department of Public Service Regulation and the Montana Public Service Commission in Mountain Water's action for a

declaratory judgment that Mont. Code Ann. § 69-4-511 (1989) is unconstitutional under the fourteenth and fifth amendments. The statute at issue requires privately- but not publicly-owned Montana water utilities to reimburse their customers for certain costs of repair of customers' individually-owned water service lines. We affirm the district court's judgment that the statute is constitutional.

FACTUAL AND PROCEDURAL BACKGROUND

Under Montana's regulatory structure, cities and towns are responsible for regulating their publicly-owned water utilities. Mont. Code Ann. §§ 69-7-101 to -201 (1989). The Montana Public Service Commission ("PSC"), an executive branch of the state (Mont. Code Ann. §§ 2-15-2601, 2602 (1989)), is responsible for regulating privately-owned water utilities. Mont. Code Ann. §§ 69-3-101, 102 (1989). All but two of Montana's major water utilities are publicly-owned and therefore regulated by cities and towns. Mountain Water is one of the two major privately-owned water utilities regulated by the PSC.

Customers of privately-owned water utilities in Montana own the water service lines running between their premises and the water main in the public street. Before 1987, these customers of privately-owned water utilities bore both the financial and actual responsibility for the maintenance of their service lines. Mont. Admin. R. 38.5.2502(5)(1987). These customers were therefore liable for costs or damages arising not only from repairs of service lines occurring on their own property, but also

arising from repairs occurring past their property boundaries and in the public street.

In 1987, Montana State Senator Lynch introduced a bill in the legislature making all Montana water utilities, whether publicly- or privately-owned, liable for costs or damages arising from the repair of customer service lines past customers' property boundaries. SB 28, Mont. 50th Leg., Reg. Sess. (1987). Senator Lynch testified to his personal difficulties when the Butte Water Company, Montana's other major privately-owned water utility, insisted that he take responsibility for repair of his service line in the public street. *Senate Hearings on SB 28 Before the Local Gov't Comm.*, Mont. 50th Leg., Reg. Sess., 1 Jan. 13, 1987) (statement of Sen. Lynch). He also testified to his belief that in some Montana cities, publicly-owned utilities already bore the liability for costs and damages arising from the repair of customer service lines in the street. *Id.* After hearings in both houses, the Montana legislature passed an amended version of Senator Lynch's bill but exempting publicly-owned water utilities from liability for these costs.

Senator Lynch's bill (hereafter, "liability statute") as enacted was codified at Mont. Code Ann. § 69-4-511. This statute provides that:

> (1) A property owner is responsible for the costs of constructing privately supplied water service pipelines from the main to his premises and for maintaining service pipelines from his property line to his premises. The private water service provider is responsible for the cost of maintaining water service pipelines from the main to the owner's property line, except that

> the property owner shall pay for pipe and other supplies used in maintaining water service lines between the main and his property line.
>
> (2) A property owner is not liable for any injury or property damage associated with excavation in maintaining water service pipelines if the excavation does not occur between his property line and his premises.

This liability statute makes privately-owned Montana water utilities liable for most of the costs of repair of individual customers' service lines between customers' property boundaries and the utility's main. Privately-owned water utilities must reimburse their customers under the liability statute for costs of these repairs. Further, by exempting customers from liability for injuries caused by repair of their lines past their property boundaries, the liability statute apparently makes the privately-owned water utility also responsible for damages arising from the repairs.

Mountain Water sued in federal district court for a declaratory judgment that the liability statute violates equal protection guarantees of the fourteenth amendment and the uncompensated "takings" clause of the fifth amendment.[1] Mountain Water and the PSC stipulated to

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[1] After submission of this case, this court *sua sponte* questioned whether we have jurisdiction. The parties then briefed the issues of ripeness and federal question jurisdiction. We conclude we have jurisdiction over Mountain Water's facial challenge to the constitutionality of the state liability statute under the line of authority stemming from *Ex parte Young*, 209 U.S. 123 (1908). *See* 13 Wright, Miller & Cooper, *Federal Practice and Procedure* § 3524 at 151-154 (1984 & Supp. 1990). We note, however,

the facts and filed cross motions for summary judgment. The district court granted summary judgment for the PSC, upholding the constitutionality of the liability statute. Mountain Water timely appealed to this court.

DISCUSSION

1. *Standard of Review*

We review the district court's grant of summary judgment de novo. *Kruso v. Int'l Tel. & Tel.*, 872 F.2d 1416, 1421 (9th Cir. 1989), *cert. denied*, U.S., 110 S. Ct. 3217 (1990). We note that the parties present no issues of disputed fact and argue their positions as a matter of law. Our review on appeal thus focuses on the constitutional issues Mountain Water raises which we review de novo also. *Jackson Water Works v. Public Util. Comm'n*, 793 F.2d 1090, 1092 (9th Cir. 1986), *cert. denied*, 479 U.S. 1102 (1987).

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that eleventh amendment immunity bars *Ex parte Young*-type actions against arms of the state, *See id.* Mountain Water's complaint names arms of the state and thus may implicate Montana's eleventh amendment immunity if Montana has not consented to suit. Because neither Mountain Water nor Montana have argued eleventh amendment immunity either below or on appeal, we decline to decide this question. *See Roberts v. College of the Desert*, 870 F.2d 1411, 1415 (9th Cir. 1989) (citing *Patsy v. Board of Regents*, 457 U.S. 496, 515 n.19 (1982)). While eleventh amendment immunity bears on our jurisdiction, we may for prudential reasons decline to raise the issue *sua sponte*. *Patsy*, 457 U.S. at 515 n. 19. We therefore identify no jurisdictional impediment to our deciding the merits of this case.

II. *Mountain Water's Equal Protection Challenge*

A. Rational Relation Test

Mountain Water contends that the liability statute's distinction between publicly- and privately-owned water utilities, classifying only privately-owned utilities for liability, violates the fourteenth amendment's equal protection guarantee.

The challenged liability statute is an economic regulation, and thus commands constitutional scrutiny most deferential to the legislature. *See Jackson Water Works*, 793 F.2d at 1093. To satisfy equal protection requirements, where a challenged statute implicates no suspect class, we must determine only whether the statute's classification scheme is rationally related to a legitimate governmental purpose. *Kadrmas v. Dickinson Pub. Schools*, 487 U.S. 450, 457-58 (1988). In our review of governmental purposes, moreover, we need not rely only upon those purposes the legislature, litigants, or district court have espoused, but may also consider any other rational purposes possibly motivating enactment of the challenged statute. *See id.* at 463.

Lacking an express statement of legislative purpose in this case,[2] the district court held that the purpose of

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[2] From the record it appears that the Montana legislature made no findings of fact concerning the liability statute legislation. The only legislative statement of purpose for the enactment of the bill, moreover, was contained in its title, "AN ACT TO CLARIFY A PROPERTY OWNER'S FINANCIAL RESPONSIBILITY AND LIABILITY FOR . . . MAINTENANCE OF . . . WATER SERVICE PIPELINES. . . . " SB 28, Mont. 50th Leg., Reg. Sess. (1987).

the liability statute is to help assure proper maintenance of customer service lines. Proper repair of these service lines is essential to the integrity of any water system, and so is manifestly a legitimate governmental purpose. The Montana legislature may have plausibly believed that customers would repair their service lines sooner or to higher standards were they assured a utility would reimburse them for the costs.

Mountain Water argues, however, that the liability statute's distinction between publicly- and privately-owned utilities is not rationally related to this purpose of enhanced maintenance. Mountain Water points out that the statute cannot effectively enhance maintenance of Montana water systems because, by exempting publicly-owned utilities, the statute exempts all but two of Montana's major water utilities from liability. Further, the statute imposes no affirmative duty on the privately owned utilities to repair customer service lines. Instead, the liability statute leaves to individual customers' discretion whether and to what standards they repair their own service lines.

If the liability statute's exemption of publicly-owned utilities must be rationally related to the statute's ostensible purpose of enhancing service line repair, then Mountain Water is correct that the statute's classification of water utilities into publicly- and privately-owned bears little relationship to its purpose. Equal protection analysis, however, demands no such precise nexus between the challenged statute's classification and the statute's overall purpose. Rather, the liability statute's distinction between publicly- and privately-owned utilities must withstand Mountain Water's challenge unless it is " 'so

unrelated to the achievement of *any combination* of legitimate purposes' " that a court must " 'conclude that the legislature's actions were irrational.' " *Kadrmas*, 487 U.S. at 462-63 (quoting *Vance v. Bradley*, 440 U.S. 93, 97 (1979)) (emphasis added). We must therefore consider any other possible purposes the Montana legislature might have sought to achieve in enacting the liability statute exempting publicly-owned utilities.

We note Montana's regulatory scheme entrusting the regulation of publicly-owned water utilities to the cities and towns which own them. Mont. Code Ann. §§ 69-7-101 to -201 (1989). The Montana legislature could have included publicly-owned utilities in the liability statute's mandate, although it might have had to amend statutes authorizing local control of publicly-owned utilities to do so. It seems, however, that the Montana legislature preferred to permit the individual localities to decide whether to impose similar liability on their local, publicly-owned water utilities. Cities and towns regulating their own publicly-owned water utilities also have the authority to impose liability for repair costs on their own water utilities, just as the legislature has imposed liability for repair costs on privately-owned utilities through the liability statute. *See* Mont. Code Ann. § 69-7-201 (1989). Moreover, the liability statute's applicability to privately-owned water utilities is also consonant with Montana's regulatory scheme. In enacting the liability statute, the legislature regulated only those water utilities still wholly subject to state regulation through the PSC; that is, privately-owned water utilities. Fidelity to a regulatory scheme entrusting regulation of publicly-owned utilities to localities and regulation of privately-owned utilities to

the state is also manifestly a legitimate governmental purpose.

Given the combined legislative purposes of enhancing service line maintenance and of continuing to empower localities to regulate their own publicly-owned water utilities, we hold that the liability statute's distinction between publicly- and privately-owned water utilities is rationally related to legitimate government purposes. We also note that Montana localities' failure to impose liability on their publicly-owned water utilities as the state has imposed liability on privately-owned water utilities through the liability statute does not defeat the liability statute's rational relationship to legitimate government purposes. Such disparity in regulation between locally and state controlled water utilities may merely represent legitimate autonomous local choices.

B. "Heightened Scrutiny"

Mountain Water contends, however, that we should closely examine the Montana legislature's actual motive in exempting publicly-owned water utilities from the liability statute. Relying on *USDA v. Moreno*, 413 U.S. 528 (1973), Mountain Water urges "heightened scrutiny" of the liability statute's relation to legitimate government purposes. In *Moreno*, the Supreme Court decided that disqualifying members of unrelated households from receiving food stamps was wholly irrelevant to the ostensible purpose of preventing fraud. *Id.* at 537-38. Instead, and as the legislative history revealed, Congress's only purpose in enacting the disqualification was to harm

hippie communes, "a politically unpopular group." *Id.* at 534.

Mountain Water adduces a legislative record in this case of the sponsoring Senator's testimony about his personal difficulties with a privately-owned water utility in the repair of his home's service line. Mountain Water asserts that neither a concern for service line repair generally nor the distinction between PSC and local regulation of water utilities prompted enactment of the amended liability statute. Instead, according to Mountain Water, the legislature's sole purpose in enacting the liability statute was, as in *Moreno*, to harm a temporarily "politically unpopular group," privately-owned water utilities.

Under the *Moreno* analysis, a court may hold a statute not implicating a suspect class violative of equal protection if the statute serves no legitimate governmental purpose and if impermissible animus toward an unpopular group prompted the statute's enactment. *See Moreno* at 534, 538. We have already considered the governmental purposes the liability statute serves in this case and have held them legitimate. Moreover, our de novo review of the record in this case fails to support Mountain Water's allegations about the Montana legislature's or even the sponsoring Senator's animus toward privately-owned water companies. Though, as with much legislation, personal experience may have inspired Senator Lynch to draft the bill, his original bill imposed liability for repairs and damages on *all* Montana water utilities, not just those privately owned. Further, Senator Lynch and his colleagues favoring the bill agreed that water service line repair was a statewide problem worthy of legislative

attention. *House Hearings on SB 28 Before the Local Government Comm.*, Mont. 50th Leg., Reg. Sess., 10 (Mar. 6, 1987) (statements of Sen. Lynch, Rep. Brown, Rep. Pistoria). The legislature finally amended Senator Lynch's bill to exempt publicly-owned water utilities from liability, but, as we have noted, it may have done so to assure that regulation of publicly-owned water utilities remained a local prerogative. *See, e.g., id.* at 6 (comment of Rep. Squires). The record thus evinces no impermissible motive in the Montana legislature's consideration of Senator Lynch's bill or in amending it to exempt publicly-owned water utilities. Moreover, and also unlike the hippie communes in *Moreno*, privately-owned water utilities are neither members of a suspect class nor a politically unpopular group prompting "heightened" scrutiny in equal protection analysis from this court. We therefore hold that the *Moreno* analysis for equal protection is inapplicable to this case.

III. *Mountain Water's Fifth Amendment Challenge*

The fifth amendment commands: "nor shall private property be taken for public use without just compensation." U.S. Const. amend. V. The fourteenth amendment makes the fifth amendment's prohibition applicable to the states. *Webb's Fabulous Pharmacies v. Beckwith*, 449 U.S. 155, 160 (1980). We agree with the district court and the parties in this case that by requiring Mountain Water to reimburse its customers for repairs to their privately-owned service lines, the liability statute effects a taking of Mountain Water's property. Mountain Water argues that the liability statute fails to fulfill the "public use" and

"just compensation" requirements of the fifth amendment.

A. Public Use

Mountain Water points out that the liability statute forces Mountain Water to expend its privately-owned funds to reimburse its private customers for their costs in repairing their individually-owned service lines. Noting that " 'one person's property may not be taken for the benefit of another private person without a justifying purpose.' " *Hawaii Hous. Auth. v. Midkiff*, 467 U.S. 229, 241 (1984) (quoting *Thompson v. Consolidated Gas Corp.*, 300 U.S. 55, 80 (1937)), Mountain Water contends that the liability statute effects a taking of its private property solely for the purpose of benefiting its private customers. The liability statute serves no public purpose of enhancing maintenance of water systems, Mountain Water argues, because the repair of service lines remains the customer's sole prerogative, the statute imposes no new "service obligation" on Mountain Water to maintain the lines, and all the statute accomplishes is a forced transfer of money from Mountain Water to private individuals, its customers proceeding with repairs.

In *Hawaii Housing Authority v. Midkiff*, the Supreme Court emphasized the deference courts owe to legislative determinations of public use. *Midkiff*, 467 U.S. at 241-43. A taking satisfies the constitutional public use requirement if it advances a "conceivable public purpose" and regardless of whether it succeeds in realizing that purpose. *Id.* at 241-42. Moreover, it is not necessarily constitutionally relevant that the statute may force the transfer

of private property, as here, from one private entity or individual to another. *Id.* at 243-44. Because we have decided that the Montana legislature could have rationally conceived that the liability statute would enhance service line maintenance, we hold that the statute effects a taking for a public use even if the statute proves ineffective in achieving that purpose.

Moreover, the liability statute may serve the additional public purpose of redistributing the cost of service line repairs. Prior to enactment of the liability statute, customers of privately-owned water utilities bore sole financial responsibility for service line repair costs. The liability statute not only shifts this financial burden from the customer to privately-owned utilities, but also redistributes the financial burden among all the customers of the utility. The statute accomplishes this redistribution by forcing privately-owned utilities to request higher rates to cover their expenses in reimbursing customers whose service lines require repair. By paying these higher rates, all the customers of a privately-owned utility share in the cost of repairing some of the customers' service lines. The liability statute thus redistributes the cost of service line repair from individual customers to all customers through higher rates, and it employs the privately-owned utility as the agent for that redistribution. This possible redistribution purpose is also a public use, and we defer to the wisdom of the legislature in requiring that public use of Mountain Water's private property. *See Midkiff*, 476 U.S. at 242-43.

B. Just Compensation

The dedication of private utility property to public use "creates its own set of questions under the Takings Clause of the Fifth Amendment," usually answered by an analysis of utility rate structures and whether those rates justly compensate the utility. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, ___, 109 S. Ct. 609, 615 (1989). The district court held that Mountain Water's recourse as a utility to obtain just compensation for the property taken under the liability statute is to seek rate increases before the PSC. We agree.

Mountain Water attempts to distinguish its case from the traditional line of fifth amendment utility rate cases by its characterization of the property taken. Mountain Water argues that its funds used to reimburse customers for repairs under the liability statute are not services in which the public has an interest and for which Mountain Water can seek compensation in the form of rates. Dedication of a utility's private property to services for the public, of course, characterizes the usual fifth amendment utility rate case. *See id.* In this case, Mountain Water argues, its funds are accumulated profits from past operations in which the public has no interest. *See Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 32 (1926). Under Mountain Water's analysis then, the liability statute's taking of these funds necessitates a judicial eminent domain action, just as the taking of a parcel of land would so necessitate. Unlike judicial eminent domain proceedings, Mountain Water points out, PSC rate setting is prospective. PSC rate setting therefore, cannot compensate Mountain Water dollar-for-dollar for the funds the utility must transfer to its customers.

We must reject Mountain Water's subtle distinctions for several reasons. First, the capital funds character of the property taken from Mountain Water is constitutionally irrelevant. A state may compensate through rates the dedication of a utility's private property to public use whether that property is plant, operations, or capital funds. As the Supreme Court "reaffirmed" in *Duquesne Light*, "all of the subsidiary aspects of valuation for rate-making purposes [cannot] . . . properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree." *Id.*, 488 U.S. at ___, 109 S.Ct. at 617 (citing *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944)). Given legislative authority to dedicate Mountain Water's private funds for public use, which Mountain Water concedes, the PSC may value those funds along with Mountain Water's plant and other private property in a PSC rate order.

Second, that Mountain Water must seek just compensation through PSC rate setting rather than through an eminent domain action is not of constitutional significance.[3] Only if the PSC's rate order fails to compensate Mountain Water justly for all of its private property dedicated to public use can Mountain Water complain of a violation of its fifth amendment rights. *See id.*, 488 U.S. at ___, 109 S. Ct. at 615 ("The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is

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[3] Mountain Water's objections to PSC rate-setting as "legislative" and potentially biased have no merit given this court's holding in *Jackson Water Works*, 793 F.2d at 1097.

so 'unjust' as to be confiscatory."). Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order, but not the statute, unconstitutional. *See id.*, 488 U.S. at ___, 109 S. Ct. at 619 (if the ratemaking "system fails to pass muster, it will not be because the legislature has performed part of the work"). Third, we note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's "losses" under the liability statute are not constitutionally significant unless its set rates are "unjust." *See Id.*, 488 U.S. at ___, 109 S. Ct. at 617.

Finally, we conclude that the liability statute does impose new utility "service obligations" on Mountain Water: first, to help assure service line maintenance; and second, to redistribute the cost of service line maintenance among all customers. A statute directing Mountain Water itself to perform service line maintenance would likewise have served these two purposes and there would be no question but that rates would compensate Mountain Water for its property used in performing these services. The liability statute making Mountain Water liable for the costs of repairs achieves exactly the same purposes as a statute directing the utility itself to perform repairs. The liability statute therefore imposes a utility service obligation on Mountain Water compensable through rates.

CONCLUSION

The liability statute's exemption of publicly-owned utilities is rationally related to legitimate government purposes and therefore not violative of equal protection under the fourteenth amendment. Any taking of Mountain Water private property the liability statute effects is for a public use. Mountain Water may seek just compensation for its property taken through rate setting before the PSC. The liability statute is therefore not violative of the fifth amendment. The district court's order granting summary judgment for the Montana Department of Public Service Regulation and the Montana PSC is

AFFIRMED.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MONTANA
HELENA DIVISION

* * *

MOUNTAIN WATER COMPANY,
Plaintiff,

-v-

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION,
Defendant.

CV 87-92-H-CCL

MEMORANDUM AND ORDER

(Filed July 20, 1988)

* * *

Mountain Water Company ("MWC") filed this declaratory judgment action seeking an injunction against the Public Service Commission ("PSC") from enforcing the provisions of Chapter 184, Session Laws of Montana, 1987, ("Act"), codified in part as Section 69-4-511, Montana Code Annotated, and Rule 38.5.2502 of the Administrative Rules of Montana ("ARM"), and a declaratory judgment of unconstitutionality.

MWC claims the Act violates the United States Constitution in that: (1) it constitutes an unlawful taking in violation of the fifth and fourteenth amendments to the United States Constitution; (2) it denies MWC equal protection of the law in violation of the fifth and fourteenth amendments to the United States constitution; and (3) it constitutes an impermissible bill of attainder in violation

of Article I, Section 10, Clause 1, of the United States Constitution.

The parties each filed motions for summary judgment. Defendant filed a motion to amend the answer, and a hearing was held on all motions on April 13, 1988. After careful consideration, the court now rules on the motions.

Background

In 1987, the Montana legislature passed the Act, effective October 1, 1987, which clarified the property owner's responsibility for maintenance of privately supplied water service pipelines and directed an amendment to Section 5 of Rule 38.5.2502 of the Administrative Rules of Montana. 1987 Laws of Montana, Chapter No. 184. Essentially the Act deals with maintenance of privately supplied water service pipelines from the main to the consumer's property lines.

Prior to the passage of this Act, all expenses of laying and maintaining the service lines from the main to the premises were borne by the property owner. The passage of the Act changed this responsibility so that now the "private water service provider is responsible for the cost of maintaining water service pipelines from the main to the owner's property line, except that the property owner shall pay for pipe and other supplies used in maintaining water service lines between the main and his property line." Mont. Code Ann. § 69-4-511(1). The property owner is still responsible for maintenance and cost of supplies used to repair water service pipelines from the property line to the premises.

Section 2 of the statute states that the property owner is not liable for any injuries or property damage "associated with excavation in maintaining water service pipelines if the excavation does not occur between his property line and his premises." Mont. Code Ann. § 69-4-511(2).

Motion to Amend the Answer

Defendant moved to amend the answer, in order to claim insufficient knowledge to admit or deny that the property owners own the water service lines. Defendant admitted that property owners own the service lines in its original answer. Plaintiff objected to the motion to amend on grounds that it is without basis, wholly unsupported and asserted that Defendant is not able to show a prima facie ability to establish factual support for the denial of its previous admissions.

The decision to grant a motion to amend is entrusted to the sound discretion of the trial court. *DCD Programs Ltd. v. Leighton*, 833 F.2d 183, (9th Cir. 1987). In absence of prejudice to the opposing party, leave to amend should be freely given. *Id.; Wyshak v. City National Bank*, 607 F.2d 824 (9th Cir. 1979).

In this instance, the amended answer would not unduly prejudice the Plaintiff and was not dilatory in nature. However, Defendant, for the purposes of the summary judgment motions agreed that there are no genuine issues of material fact and did not object to the supporting documents submitted by Plaintiff which address the issue of the private ownership of water service lines.

Therefore, the court finds that the motion to amend the answer is moot.

Motions for Summary Judgment

The parties filed simultaneous motions for summary judgment. Defendant moved for summary judgment as to all relief prayed for by Plaintiff in the Complaint while Plaintiff moved for summary judgment only on the claims of unconstitutional taking and equal protection. Plaintiff later moved for summary judgment on the remaining claim, that the Act is an impermissible bill of attainder.

Summary judgment is properly granted under Rule 56(c) only if the "pleadings and supporting materials show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *California Architectural Products, Inc. v. Franciscan Ceramics,* 818 F.2d 1466, 1468 (9th Cir. 1987), *cert denied,* 108 S. Ct. 699 (1988). The parties agree that there are no genuine issues as to any material facts.

Prohibited Taking

Plaintiff MWC alleges that the law in question takes the private property of MWC and appropriates it for the maintenance of the private property of others in violation of the fifth and fourteenth amendments of the United States Constitution.

MWC claims that this is an uncompensated taking for private use. MWC alleges that by requiring the private water supplier to pay for the maintenance of the service

lines, the state is in effect taking "property," in this case money, from MWC and giving it to the private property owner. A state has police power to regulate public utilities and when that regulation impairs property interests to such an extent that it is considered a "taking" then just compensation is required. *Pennsylvania Coal v. Mahon Co.*, 260 U.S. 393 (1922).

The PSC may regulate public utilities through powers granted by the Montana legislature. Mont. Code Ann. § 69-3-101 *et. seq.* The rates set by the PSC through its rate-making policies must be at a level that allow a just compensation for any regulations imposed which impair the property interests of the utility company. *West Ohio Gas Co. v. Public Utilities Commission of Ohio,* 294 U.S. 63 (1935). Compliance with the Act and the accompanying regulation will mean that MWC will incur additional operating expenses. These expenses will be a part of the data presented by MWC when applying to the PSC for additional rate increases.

MWC argues that this "taking" is not just an impairment of property interests in the form of additional operating expenses which can be compensated for in future rate increases. MWC claims instead that each time the state requires MWC to pay for the maintenance of a service line, it is in effect taking money from MWC and giving it to the property owner. This type of "taking" falls under the line of cases dealing with traditional eminent domain rather than those dealing with regulation and requires just compensation prior to the taking or payment with interest. *United States v. Kalmath and Mondoc Tribes* [sic], 304 U.S. 119, 123 (1937). MWC argues that the procedure set out for compensation through an increase

in rates does not adequately compensate MWC because it does not allow for prepayment or payment with interest. The Act does not allow the state to take private property and give it to a private entity. Rather, the Act places an additional service obligation on the property interests of the utility company for which it will be compensated by an increase in rates if necessary.

In order to establish that there is not a prohibited taking, there must not only be adequate compensation, but the taking must be for a public use. MWC claims that this Act takes money from MWC and gives it to a private entity without a justifying public purpose. One person's property may not be taken for the benefit of another private person even though compensation is paid if it is not for public use. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984).

There is no question that the maintenance of water service lines has a public purpose. The public is affected when there is a problem with water service lines, not only because of a potential loss of service, but also because of the loss of water. The law enacted by the Montana legislature does not constitute a prohibited taking.

Equal Protection

In its second claim, MWC argues that the Act denies MWC equal protection of the law in violation of the fifth and fourteenth amendments because it burdens private water suppliers only and does not place this obligation on municipal water suppliers.

> The Equal Protection Clause of the Fourteenth Amendment commands that no State shall

> "deny to any person within its jurisdiction the equal protection of the laws," which is essentially a direction that all persons similarly situated should be treated alike. (citations omitted)

Cleburne v. Cleburne Living Center, 473 U.S. 432, 439 (1985).

Legislative bodies traditionally have been given wide latitude in constructing particular laws when they involve economic legislation and the classification involved is not based on race, sex, religion or age. The general rule is that legislation is presumed to be valid and will be sustained if the classification set out is rationally related to a legitimate state interest. *Id.* at 440.

In the briefs submitted discussing the analysis of a "taking" for a public use, the PSC indicated that the maintenance of a water system is in the public interest because of the interconnectedness of the water system within a community and because a poorly maintained water system would affect other things of public interest including streets, alleys, sewer lines, gas lines and underground telephone and electric lines. Brief in Support of Defendant's Motion for Summary Judgment at 18. The state has a legitimate interest in the maintenance of water service lines.

Next it must be determined that the classification scheme set out in the statute is rationally related to the legitimate state purpose. "The term rational, of course, includes a requirement that an impartial lawmaker could logically believe that the classification would serve a legitimate public purpose that transcends the harm to the members of the disadvantaged class." *Cleburne*, 473 U.S. at 452 (concurring opinion).

The law being challenged does not require that water service lines must now be maintained where there was no requirement of maintenance before. Prior to October, 1987, Rule 38.5.250, *et. seq.* ARM set out rules for privately-owned water utilities. Rule 38.5.2505(5) required that the cost of constructing and maintaining water service lines from the main to the premises must be borne by the property owner. The 1987 amendment to this rule merely changed the party responsible for the maintenance of the water service line from the main to the property line. It did not change the parties to whom the rules apply. MWC argues that the classification which makes the law applicable only to private water suppliers and not to municipal water suppliers is unconstitutional because there is no rational basis for the classification. The PSC argues to the contrary.

Public utilities are regulated under Montana law by the PSC. The definition of "public utility" as set out in Mont. Code Ann. § 69-3-101(1) includes both privately and publicly owned utilities which furnish "(e) except as provided in Chapter 7, water for business, manufacturing, household use, or sewage service whether within the limits of municipalities, towns, and villages or elsewhere;" Mont. Code Ann. § 69-3-101(e). The exception set out in chapter 7 is the municipally owned utility. Section 69-7-201 states in part: "Each municipal utility shall adopt, with the concurrence of the municipal governing body, rules for the operation of the utility."

Although the Montana legislature could require that the statute at issue here apply to both private and municipal water suppliers, the law as passed does rationally further the statutorily designed structure for regulation

of utilities. The municipalities are free to adopt the same service regulation for municipal water suppliers upon obtaining the concurrence of the municipal governing body.

The statute does not deny MWC equal protection of the laws.

Bill of Attainder

MWC's third claim is that the Act constitutes a bill of attainder in violation of article I, section 10, clause I of the United States Constitution. Bills of attainder require two elements: First, a specific designation of persons or groups as subjects of the legislation, and, second, an infliction of a legislative punishment. *Nixon v. Administrator of General Services*, 433 U.S. 425, 472-73 (1976).

The Act, as passed, singles out private water suppliers as the subject of the legislation. The extent of specificity needed to satisfy this first element of a bill of attainder is not met just because the legislature burdens some persons or groups but not all other plausible persons or groups in a given situation. *Id.* at 471. The rational basis for this specificity was discussed in the analysis of the equal protection doctrine.

Next the court must determine if the Act imposes a legislative punishment. The courts have developed three tests by which to make this determination: first, is the burden imposed by this Act comparable to those that

have historically been considered a legislative punishment; second, does the Act further any nonpunitive legislative purposes; and third, does the legislative record indicate an intent to punish. *Id.* at 473-80.

Historically impermissible punishments have included imprisonment, banishment, punitive confiscation of property and barring individuals or groups from participation in specified employments or vocations. *Id.* at 474. MWC argues that this is a punitive confiscation of property. This issue was discussed in the analysis of Plaintiff's first claim where the court found that there was no "taking without just compensation." The Act then does not impose a punitive confiscation of property.

The purpose and rationale of the Act was discussed within the analysis of the equal protection claim. Where legitimate justifications for the passage of the Act are apparent the act cannot be considered to be punitive legislation. *Id.* at 477.

The third test requires a look at the legislative history of the Act in order to determine if there was an intent to punish. There is no question from the materials submitted to the court that Senator Lynch, the initial proponent of the Act, was unhappy with the Butte Water Company. However, this fact by itself does not make the Act a bill of attainder.

The Act as originally written was to pertain to all water suppliers both private and municipally owned. The record indicates that opposition to the Act as first presented came from representatives of both private and municipal water suppliers. The opposition came because of the additional costs which would be imposed and the

inability to handle the added requirement administratively. Opposition also came because of a feeling that the bill would be unfair to the individual rate payers who had already personally paid to upgrade and maintain their water service lines and would now, through an increase in rates, be sharing the cost of maintaining other rate payers' service lines as well.

The court agrees that the Act is not necessarily a fair or wise piece of legislation. There is no question that this Act raises some problems for private water suppliers. The Act, however, is not unconstitutional. Therefore,

IT IS HEREBY ORDERED that judgment shall enter for Defendant and against Plaintiff.

The clerk is directed forthwith to notify counsel of entry of this order.

Done and dated this 19 day of July, 1988.

/s/ Charles C. Lovell
CHARLES C. LOVELL
United States District Judge

THE SUPREME COURT OF THE STATE OF MONTANA

No. 91-446

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff and Respondent, -v- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL, Defendants and Appellants.	ORDER (Filed Aug. 13, 1992)

Plaintiff and Respondent has filed a petition for rehearing in the above cause and Defendants and Appellants have filed its objections to the petition. The petition and the objections having been examined by this Court

IT IS ORDERED that Opinion No. 91-446 shall be clarified on pages 4 and 5 as follows:

> The PSC is an administrative agency charged, through powers granted by the Montana Legislature, with regulating public utilities pursuant to the provisions of §§ 69-3-101, MCA et seq. The rates set by the PSC through its ratemaking ~~policies~~ rules must be at a level that allows a just compensation for any regulations imposed which impair the property interests of the utility company. West Ohio Gas Co. v. Public Utilities Commission of Ohio (1935), 294 U.S. 63, 55 S.Ct. 316, 79 L.Ed. 761. MWC argues that the

PSC is bound by judicial estoppel. The PSC admitted during the course of the federal litigation that § 69-4-511, MCA, was a taking and that MWC would be compensated through rate-making.

However, in making that admission the PSC did not waive application of the ~~policies~~ rules involved in rate-making. In Montana, public utility rates are set to match utility costs during the period that rates are in effect. The utility, the Montana Consumer Counsel, the PSC, or other persons with standing may seek a rate change when the financial information indicates a mismatch. See § 69-3-301, MCA et seq. MWC was aware that the Montana Legislature passed § 69-4-511, MCA. Prior to the law taking effect on October 1, 1987, MWC could have applied to the PSC to cover the utility costs for 1988 and 1989 under § 69-4-511, MCA.

IT IS FURTHER ORDERED the petition for rehearing is denied.

DATED this 13th day of August, 1992.

/s/ John Conway Harrison
/s/ Karla M. Gray
/s/ R.C. McDonough
/s/ Terry Trieweiler
/s/ William E. Hunt Sr.
Justices

August 13, 1992

CERTIFICATE OF SERVICE

I hereby certify that the following order was sent by United States mail, prepaid, to the following named:

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ED SMITH
CLERK OF THE SUPREME COURT
STATE OF MONTANA
BY: /s/ JH
Deputy

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * *

IN THE MATTER of the Application of MOUNTAIN WATER COMPANY for Authority to Increase Rates for Water Service	PSC DOCKET NO. 89.6.23 OPENING BRIEF

STATEMENT OF THE CASE

A. INTRODUCTION

This case is an application by the Mountain Water Company (MWC) for authority to increase the rates it is authorized to charge its customers in its Missoula Division. The application, filed with the Commission on June 29, 1989, sought an increase in annual revenues in the amount of $804,241. The filing was denominated PSC Docket 89.6.23.

In December of 1989, the Montana Consumer Counsel (MCC) prefiled the testimony of Mr. Frank E. Buckley, Rate Analyst for the MCC. Mr. Buckley conceded an annual revenue deficiency in the MWC rates for its Missoula Division in the amount of $374,516. On December 22, 1988, the Commission entered its Interim Order 5449 in the docket authorizing a rate increase for the Missoula Division in the amount of the revenue deficiency conceded by the MCC.

This case came on for hearing on January 30, 1990. MWC and the MCC appeared through counsel and gave evidence.

B. SUMMARY OF TESTIMONY

MWC presented its case in chief through the prefiled direct testimony of Mr. E. Lee Magone, Vice President and General Manager of MWC, and Mr. Don Cox, CPA, rate consultant to the Company. Mr. Magone provided a general overview of the Company's operations and the need for a general rate increase. Mr. Cox presented a detailed cost of service in accordance with the Commission's minimum filing requirements, ARM

* * *

THE ISSUES

A. SENATE BILL 28 EXPENSE

Senate Bill 28 of the 1987 Montana legislature, enacted into law as § 69-4-511, MCA, imposes a very unique and substantial financial burden upon MWC. It obligates MWC to reimburse its customers, or their insurance carriers, for the expenses incurred by those customers in maintaining their own private property, the water service lines of the MWC customer. It legislates a direct transfer of assets (money) from MWC to its customers or their insurance carriers. The transfer is so direct and concrete that MWC has challenged the statute in federal court as an unconstitutional taking of private

property in violation of the Fifth and Fourteenth Amendments.[8]

The Commission, as the enforcing state agency, was obligated to defend the statute against the MWC challenge. In its brief to the United States District Court, it frankly admitted that the direct transfer of assets mandated by SB 28 was a taking, but asserted that it passed constitutional muster because the ratemaking process would provide adequate compensation for the taking.[9] The Commission went so far as to explain how the ratemaking process would even permit recovery of expenses incurred by a water utility prior to its first rate case succeeding enactment of the statute:[10]

> The PSC has not made a decision on the treatment of Mountain Water's SB 28 cost because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer no loss as a result of SB 28.

This is the first MWC rate case since enactment of SB 28 into law. MWC's proposed ratemaking treatment for the expenses it has already incurred in complying with SB 28 is in accordance with the Commission's representations to the federal court. It is against that background that the proposal of the MCC to deny MWC the recovery of these expenses must be considered.

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[8] MWC's court challenge also attacks the statute under the Equal Protection Clause of the Fourteenth Amendment.

[9] See prefiled testimony of E. Lee Magone, Ex. C, pp. 3-4.

[10] Commission Brief to the United States District Court dated January 29, 1988, p. 8.

As of December 31, 1989, MWC has paid over to its customers, in compliance with SB 28, $165,000.[11] The MCC proposal to deny MWC the recovery of that $165,000 is patently unreasonable. Where is the equity in state action which compels MWC to pay over $165,000 in its assets to its customers then denies it the recovery of those expenses in its cost of service? From what unreasonable action by MWC is the MWC ratepayer being protected by the denial of the recovery of such expenses? What possible public policy is being served by such punitive action? Where is the just compensation under the Fifth and Fourteenth Amendments, promised by the Commission in its representations to the United States District Court? The Commission is legally and morally bound to continue the course it set in the SB 28 litigation, and to permit MWC to recover from its ratepayers at large the money it had to pay out to specific MWC customers in obedience to SB 28. The Commission should permit the inclusion in rate base of $165,000 in SB 28 expenses incurred in 1988 and 1989, together with a rapid amortization of that amount. It should also institute a tracking mechanism so that future costs can be expeditiously and accurately recovered.

The federal court litigation instituted by MWC was a facial challenge to SB 28. If the Commission adopts the MCC proposal to deny MWC the actual recovery of its SB 28 expenses, it will permit MWC to again litigate the

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[11] Mountain Water paid out $74,355 to its customers in 1988, page 157.3 of the Company's financial data. It paid out $90,753 in 1989, prefiled rebuttal testimony of Lee Magone, Ex. C, internal exhibit ELM-1.

constitutionality of SB 28 on an as applied basis. If the Commission's goal is to preserve SB 28, its acceptance of the MCC proposal would seriously undermine that goal.

B. RATE CASE EXPENSE

In PSC Docket 86.9.51, MWC estimated its rate case expense to be $50,000.

* * *

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * *

IN THE MATTER of the Application of MOUNTAIN WATER COMPANY for Authority to Increase Rates for Water Service.	PSC DOCKET NO. 89.6.23 MOTION FOR RECONSIDERATION (WITH BRIEF)

COMES NOW, Mountain Water Company, the applicant in the above-entitled proceeding, and moves the Commission for reconsideration of Order 5449a entered in this docket on April 5, 1990. Mountain Water integrates with this motion its brief in support of the motion, and requests reconsideration as set forth below. Specifically, Mountain Water requests reconsideration of that portion of Order 5449a which denies Mountain Water the recovery in rates of its costs of complying with § 69-4-511, MCA (SB 28) during the period January 1, 1988 to December 31, 1989.

INTRODUCTION

Mountain Water was compelled to give $165,108 of its money to its customers during the period January 1, 1988 to December 31, 1989, by the enactment of SB 28 into law. Before those transfers were compelled, Mountain Water sought to have the enforcement of SB 28 enjoined

by the United States District Court for the State of Montana as an unconstitutional taking of its private property. The Commission defended the constitutionality of the statute in that litigation. It admitted that the statute worked a taking but represented to the federal court that Mountain Water would be compensated in the ratemaking process for the expenses it would incur in complying with the statute. The federal court accepted the Commission's representations and ruled that SB 28 did not take the private property of Mountain Water without just compensation. The Commission's Order 5449a entered in this docket now denies Mountain Water the recovery in rates of the $165,108 it gave to its customers in calendar years 1988 and 1989, in compliance with SB 28.

Mountain Water did not unreasonably incur the $165,108 in compliance costs. It was compelled to incur them by the sovereign state of Montana. Mountain Water will not be unjustly enriched if it recovers its costs of complying with SB 28. It will merely recover what it has lost in compliance with the statute. The Commission's decision to deny Mountain Water the recovery of the costs it incurred in complying with SB 28 does not protect the Mountain Water customer from unreasonable action by Mountain Water. The Commission should recognize on reconsideration that the portion of its Order 5449a which denies Mountain Water the recovery of the costs it incurred during calendar years 1988 and 1989 in complying with SB 28 is inappropriate, and serves no valid public policy. The concept of fair and even-handed regulation requires that Mountain Water be permitted to fully recover its costs of complying with SB 28 during calendar years 1988 and 1989.

CORRECTION OF TECHNICAL ERRORS

The Commission's analysis contains some technical errors and flaws which appear to have affected the Commission's decision-making process. Those errors in analysis should be cured upon reconsideration.

In Findings of Fact 28 and 29 the Commission seems to indicate that the enactment of SB 28 into law made Mountain Water responsible for the actual maintenance and repair of its customer service lines. That is not correct. SB 28 has consistently been construed and applied by the Commission to only make Mountain Water liable for reimbursing the expenses incurred by either the Mountain Water customer in maintaining the water service line, or that customer's insurer which insured the water service line against deterioration.

In Findings of Fact 30 and 31, the Commission states that Mountain Water is trying to recover for expenses incurred in the 18-month period from January 1, 1988 to June 30, 1989. Mountain Water is trying to recover for the expenses it incurred in the period January 1, 1988 to December 31, 1989, a two year period. Similarly, the Commission quantifies the amount at issue as $55,766. The amount at issue is $165,108. It is an undisputed fact in these proceedings that Mountain Water incurred the following expenses in complying with SB 28:

1988	$74,355
1989	$90,753
TOTAL	$165,108

Throughout that entire period, with the exception of the last three days of 1989, the Mountain Water cost of service did not include *any* SB 28 compliance costs, either retrospectively or prospectively.[1]

The Commission indicates in its Finding of Fact 37 that Mountain Water could have made a rate filing in either 1987 or 1988 to recover the expenses it *might* incur in complying with SB 28. That indication is in contradiction of the Commission's own administrative rules. This Commission makes rates on the basis of historic test year data. Its rule ARM 38.5.106 provides:

> The statement of the cost of service shall contain an analysis of system costs as reflected on the filing utility's books for a test year *consisting of 12 months actual experience* ending no earlier than 9 months prior to the date of filing of the data required by ARM 38.5.101 and 38.5.105, unless good cause be shown. This analysis shall include the return, taxes, depreciation, and operating expenses, and an allocation of such costs to the services rendered. The information submitted with the statement shall show the data itemized below for the test period, as reflected on the books of the filing public utility. Any proposed adjustments to book costs shall be explained in writing. Such adjustments shall be shown separately and shall be fully supported, including schedules showing their derivation, where appropriate. *However, no adjustments shall be permitted unless based on changes in facilities, operations, or costs which are*

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[1] The Commission approved interim rate increase in this docket for service rendered on and after December 28, 1989.

> *known with certainty and measurable with reasonable accuracy at the time of the filing.* No adjustments will be entertained unless it will become effective within 12 months of the last month of the test period as used in this section. (Emphasis added.)

The first time that Mountain Water had a calendar year of operations in which SB 28 expenses were recorded was 1988. In other words, it was not until 1989 that Mountain Water could do anything more than wildly guess at its compliance costs, a guess expressly prohibited by the Commission's own rules. The rate case in this docket was in fact filed in 1989.

The Montana Consumer Counsel (MCC) has gone on record in support of Mountain Water's analysis of the proper interface between ARM 38.5.106 and SB 28 expenditures.[2]

> . . . MCC believes that the Commission was incorrect in finding the expenses that will be incurred by the Butte Water Company (Company) to make the repairs required by SB 28 are known and measurable changes. . . . By disregarding the phrase "at the time of filing" the orders have distorted the rule [ARM 38.5.106] beyond recognition. . . . MCC does not agree that the revised estimates provided an adjustment that was measurable with reasonable accuracy, as evidenced by the wide variation between the original and revised estimates. . . .

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[2] Montana Consumer Counsel motion for reconsideration dated March 11, 1988, and filed in PSC Dockets 87.6.30 and 87.6.31.

> *The result of the orders is simply absurd. The Commission could just as well say that up is down and on is off as to say that the Company's SB 28 adjustment is a known and measurable change.* (Emphasis added.)

The Commission seems to suggest in its Finding of Fact 43 that Mountain Water has recovered the costs it incurred in 1988 and 1989 in complying with SB 28. The Commission has no basis for making such a suggestion. It cannot be seriously contended that the rates in effect during 1988 and 1989 were based upon a cost of service which included Mountain Water's cost of complying with SB 28. The rates in effect during those two years were established in PSC Docket 86.9.51 and were based upon a cost of service derived from an historic test year ended December 31, 1985. Both the test year and the cost of service derived from that test year predated the effective date of SB 28 by almost two years. The first calendar year that SB 28 was in effect was 1988, the historic test year used in this docket. The Commission's final order in this docket has determined that the rates Mountain Water was permitted to charge its customers in 1988 failed to recover its cost of service as established by this Commission by $414,727. Part of that shortfall was because of the costs incurred by Mountain Water in complying with the provisions of SB 28.

THE COMMISSION IS NOW BOUND BY ITS SPECIFIC REPRESENTATIONS TO THE UNITED STATES DISTRICT COURT

Mountain Water filed suit in the United States District Court for the State of Montana challenging SB 28 as

an unconstitutional taking of its private property.[3] Its challenge was based upon the fact that the statute compelled Mountain Water to give its money to private parties to pay the bills they privately incurred.[4] Mountain Water cannot be compelled to part with its property, consistent with the Fifth and Fourteenth Amendments to the United States Constitution, without the State of Montana compensating Mountain Water for the loss. SB 28 had no compensation provision. Mountain Water instituted its challenge before it had incurred any losses under the bill.

The Commission, as the state agency responsible for enforcing SB 28, defended the statute against Mountain Water's constitutional challenge. It agreed that the statute took the private property of Mountain Water, but expressly represented to the federal court that Mountain Water would be compensated in the ratemaking process for the expenses it incurred in complying with the statute, Commission Brief dated January 29, 1988, p. 12:

> There is no question that Mountain Water will incur certain operating expenses as a result of compliance with SB 28. Consequently, the next

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[3] Mountain Water also challenged the statute as a violation of equal protection.

[4] In the case of the Mountain Water customer, the bill that customer incurs is part of the customer's responsibility for caring for and maintaining the customer's own private property. In the case of an insurer for the Mountain Water customer, the expense that insurer incurs is its contractual obligation to the Mountain Water customer under a contract of insurance. The insurance company enters into such contracts on a "for profit" basis.

> time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased.

And again in Commission Brief dated March 4, 1988, at p. 2-3:

> It is first necessary to repeat that SB 28 does not constitute an uncompensated taking. The Mountain Water Company is a public utility regulated by the PSC pursuant to Montana law. The PSC recognizes, as it must, that along with the obligation of a public utility to provide adequate service, goes the right of a public utility to be reasonably compensated for the use of its property in providing the service. SB 28, an exercise of the police power of the State of Montana, imposes a certain obligation on private water utilities. That obligation, along with others imposed by statute and administrative rule, can only be met through the expenditure of water utility property. For the reasonable expenditure of property, the utility must be compensated through rates paid by utility customers.

And again in the same brief at p. 8:

> The PSC, of course, defends SB 28 as a valid exercise of the state's police power for which compensation is due through rates in the special context of public utility regulation.

The United States District Court for the State of Montana accepted the representations and arguments made by the Commission during the course of the litigation. It ruled against Mountain Water and in favor of the Commission, based upon those representations. The Commission is

now bound by the representations it made to the federal court.

A party is generally estopped from taking a position directly contrary to that upon which the party succeeded in earlier litigation, ***Westlake v. Osborne,*** *230 Mont. 364, 750 P.2d 444 (1988);* ***State ex rel. Vranish v. District Court,*** *228 Mont. 59, 741 P.2d 412 (1987).* Although estoppel of the sovereign is not favored, as a general rule, estoppel will be applied to the sovereign to prevent manifest injustice, ***Mellem v. Kalispell Laundry,*** *774 P.2d 390 (1989);* ***Chennault v. Sager,*** *187 Mont. 455, 610 P.2d 173 (1980);* ***State ex rel. Stowe v. Board of Administration,*** *172 Mont. 337, 564 P.2d 767 (1973).* This is just such a case. In order to prevail in the federal court litigation, the Commission asserted in that litigation that Mountain Water would be compensated in the ratemaking process for the expenses it incurred in complying with SB 28. It made those representations despite the fact that Mountain Water specifically pointed out that the doctrine of retroactive ratemaking generally prohibited such a result. Now, after prevailing in the federal court, the Commission asserts as the basis for denying Mountain Water the recovery of its costs of complying with SB 28, the position Mountain Water unsuccessfully urged upon the federal court in the same litigation. Rudimentary concepts of equity and fair play require that the Commission be bound by the representations it made to the United States District Court.

Not only is the Commission's decision in Order 5449a unreasonable and unfair, but it is arbitrary and capricious. There is no valid policy justification for denying Mountain Water the recovery in rates of the money it gave to its customers under compulsion of SB 28. None

was stated by the Commission in its order. None can be stated.

MOUNTAIN WATER'S RATEMAKING PROPOSAL IN THIS DOCKET WAS IN ACCORDANCE WITH THE PRIOR POSITIONS OF BOTH THE COMMISSION AND THE MCC

The Commission represented to the federal court that there was a ratemaking technique available which would protect Mountain Water's right to be compensated for its cost of complying with SB 28 during the period the costs were incurred and when they could be reflected in rates, Commission Brief dated January 29, 1988, p. 8:

> The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer no loss as a result of SB 28.

Pursuant to that representation to the federal court, Mountain Water proposed in this docket to capitalize (ratebase) the losses it incurred in complying with SB 28 during the period January 1, 1988 through December 31, 1989. The capitalized amount would then be rapidly wasted (amortized) over a two year period. The Commission seems to indicate in Finding of Fact 35, that the accounting procedure proposed by Mountain Water was not what the Commission was contemplating when it made the above-quoted representation to the federal court.

It is important for purposes of reconsideration that the Commission understand the background of the Company's ratemaking proposal. The Commission's representation to the federal court did not specify the details of the appropriate accounting procedure to be utilized. However, in the Butte Water Company cases,[5] the MCC specifically delineated what it felt was the appropriate accounting procedure:[6]

> The MCC did not advocate that the Company not recover its expenses, but took the following position:
>
> > I believe these (S.B. 28 expenses) should be disallowed at this time, as they are not known and measurable. Since there may be considerable financial exposure as a result of Senate Bill No. 28, the PSC should allow BWC to capitalize these expenses and once an annual figure is determined to be representative of a normally recurring expense, then reflect in rates (1) the annual cost of such repairs, and (2) the amortization of the first year capitalized repair costs over a reasonable time frame.

That is the accounting procedure which Mountain Water proposed to utilize in this docket.[7]

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[5] PSC Dockets 87.6.30 and 87.6.31.

[6] MCC Motion for Reconsideration in PSC Dockets 87.6.30 and 87.6.31 dated March 11, 1988.

[7] The MCC has never attempted to explain how it can repudiate in this docket the procedure it contended was fair and equitable in the Butte Water company cases.

The only difference between the accounting procedure proposed by the MCC and utilized by Mountain Water, and the accounting procedure which the Commission seems to indicate is appropriate in its Finding of Fact 35, is the period of time over which the capitalized amount is wasted through depreciation or amortization. The prior decisions of this Commission have indicated a strong preference for the rapid amortization of extraordinary costs, such as those incurred by Mountain Water in complying with SB 28. That is probably why the MCC proposal in the Butte Water Company cases relied upon a rapid amortization as the wasting procedure.

If the Commission means by Finding of Fact 35 that the appropriate accounting procedure for these costs is to capitalize them and apply ordinary depreciation rates to the capitalized amounts, then it should so order upon reconsideration. It is entirely inappropriate for the Commission to deny Mountain Water the recovery of these costs simply because the Commission disagrees with the proposed period for amortization or depreciation.

THE COMMISSION'S REFUSAL TO REFLECT MOUNTAIN WATER'S COMPLIANCE COSTS IN RATES CONSTITUTES AN UNCONSTITUTIONAL TAKING OF THE PRIVATE PROPERTY OF MOUNTAIN WATER

Both the United States Constitution and the Montana Constitution forbid the State of Montana from taking the private property of Mountain Water and giving it to the Mountain Water customer. Yet, that is precisely what has occurred. The Commission, in its briefs to the federal court, *conceded* there would be an unconstitutional taking under SB 28 if Mountain Water did not recover in rates its

costs of complying with the statute, Commission Brief dated January 29, 1988 at p. 13:

> But the mere fact that a regulatory commission may disallow recovery of legitimate expenses associated with compliance with the statutory requirement does not render the statute to be complied with inherently unconstitutional. *With respect to S.B. 28, the potential exists that the PSC could disallow compliance costs which could contribute to a finding of an unconstitutional "taking."* But in such a case it would be the action of the PSC that would compromise [sic] the unconstitutional "taking"; SB 28 itself would not thereby be rendered unconstitutional (Emphasis added.)

If the Commission does not reconsider its Order 5449a entered in this docket, it will accomplish just such a prohibited result. Even if the Commission succeeds in defending SB 28 against the facial challenge instituted by Mountain Water in federal court, its current application of the statute fails constitutional muster, under both the United States and Montana Constitutions.

CONCLUSION

Mountain Water is entitled to fully recover its costs of complying with SB 28 for the period January 1, 1988 through December 31, 1989. Any straightforward notion of equity and fair play mandates such a result. If the Commission refuses to reconsider its Order 5449a, its refusal would not only be inequitable and unjust, but arbitrary and capricious, and a violation of the constitutional protection provided to private property by both the United States Constitution and the Montana Constitution.

DATED this 8th day May, 1990.

HUGHES, KELLNER, SULLIVAN & ALKE

By /s/ John Alke
John Alke
404 Fuller Avenue
P.O. Box 1166
Helena, MT 59624-1166

ATTORNEYS FOR
PETITIONER
MOUNTAIN WATER
COMPANY

CERTIFICATE OF SERVICE BY MAIL

I HEREBY CERTIFY that a copy of the foregoing **MOTION FOR RECONSIDERATION (WITH BRIEF)** was served upon the following by hand delivering a true and correct copy thereof on the 8th day of May, 1990, to:

MONTANA CONSUMER COUNSEL
34 WEST SIXTH AVENUE
HELENA MT 59620

and by mailing a true and correct copy thereof on the 8th day of May, 1990, addressed as follows:

JIM NUGENT
CITY ATTORNEY
201 WEST SPRUCE
MISSOULA MT 59801

/s/ John Alke
John Alke

JOHN ALKE
Hughes, Kellner, Sullivan & Alke
404 Fuller Avenue
P.O. Box 1166
Helena, MT 59624-1166
Telephone (406) 442-3690

ATTORNEYS FOR PLAINTIFF
AND PETITIONER

MONTANA FIRST JUDICIAL DISTRICT COURT,
LEWIS & CLARK COUNTY

* * *

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff and Petitioner, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL, Defendants and Respondents.	NO. CDV 90 607 COMPLAINT AND PETITION FOR JUDICIAL REVIEW (Filed July 26, 1990)

COMES NOW the Plaintiff and Petitioner above-named, the Mountain Water Company, and complains and alleges as follows:

COUNT ONE

1. This action is instituted pursuant to § 69-3-402, MCA.

2. Mountain Water is a Montana corporation which is engaged in the provision of water to Missoula and Superior, Montana, such activity constituting it a public utility as defined in § 69-3-101, MCA.

3. The Defendant and Respondent Montana Department of Public Service Regulation, Public Service Commission (PSC) is an administrative agency of the State of Montana charged with regulating public utilities pursuant to the provisions of §§ 69-3-101, *et seq.*, MCA.

4. The Defendant and Respondent Montana Consumer Counsel (MCC) is charged by law with representing the interests of the consuming public before the PSC. The MCC is a proper party in interest in this proceeding as the PSC orders challenged herein adopted a position advocated by the MCC before the PSC.

5. On June 29, 1989, Mountain Water filed with the PSC an application for increased water rates for its Missoula division, such application denominated PSC Docket 89.6.23. The MCC intervened in the docket. Discovery was had and expert testimony was prepared and prefiled by Mountain Water and the MCC in accordance with the rules of the PSC. On April 5, 1990, the PSC issued its Final Order 5449a in PSC Docket 89.6.23. On June 29, 1990, it issued its Order 5449b on Reconsideration.

6. Because of a personal dispute which arose in Butte, Montana, between State Senator J.D. Lynch and Butte Water Company, Montana enacted into law Senate Bill 28 of the 1987 Montana legislature, codified into law as § 69-4-511, MCA (hereinafter SB 28). The statute became effective October 1, 1987.

7. The provisions of SB 28 require a privately owned water company, such as Mountain Water, to give its money to those of its customers (or their insurers) who incur expenses maintaining that portion of their water service lines located in the street.

8. The water service lines do not belong to the privately owned water utility, but to the customer being served by the water service line.

9. Mountain Water instituted a declaratory judgment action in the United States District Court for the State of Montana to, among other things, have SB 28 declared a violation of the taking provisions of the Fifth and Fourteenth Amendments to the United States Constitution. A copy of the complaint is annexed hereto as Exhibit A and thereby incorporated herein. Mountain Water sought injunctive relief in its action.

10. The PSC defended against Mountain Water's challenge to SB 28, and opposed any grant of injunctive relief.

11. The PSC admitted to the United States District Court that SB 28 worked a taking of the private property of Mountain Water but asserted that Mountain Water would be compensated through the ratemaking process for the money it was forced to pay over to its customers in compliance with SB 28.

12. The PSC specifically represented to the United States District Court, in a brief dated January 29, 1988, at page 12:

> There is no question that Mountain Water will incur certain operating expenses as a result of

> compliance with SB 28. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased.

13. The PSC specifically represented to the United States District Court, in a brief dated March 4, 1988, at pages 2-3:

> It is first necessary to repeat that SB 28 does not constitute an uncompensated taking. The Mountain Water Company is a public utility regulated by the PSC pursuant to Montana law. The PSC recognizes, as it must, that along with the obligation of a public utility to provide adequate service, goes the right of a public utility to be reasonably compensated for the use of its property in providing the service. SB 28, an exercise of the police power of the State of Montana, imposes a certain obligation on private water utilities. That obligation, along with others imposed by statute and administrative rule, can only be met through the expenditure of water utility property. For the reasonable expenditure of property, the utility must be compensated through rates paid by utility customers.

14. The PSC specifically represented to the United States District Court in a brief dated March 4, 1988, at page 8:

> The PSC, of course, defends SB 28 as a valid exercise of the state's police power for which compensation is due through rates in the special context of public utility regulation.

15. Mountain Water argued to the United States District Court that the representations of the PSC were

untrue, and that the general doctrine prohibiting retroactive ratemaking would be applied to bar Mountain Water's recovery of the money actually paid out to its customers (or their insurers) in compliance with SB 28.

16. The United States District Court, acting upon the representations of the PSC, held that the SB 28 did not constitute an unlawful taking of Mountain Water's private property in violation of the Fifth and Fourteenth Amendments to the United States Constitution. A copy of the decision is annexed hereto as Exhibit B and thereby incorporated herein. The United States District Court specifically held at page 5 of its opinion:

> The PSC may regulate public utilities through powers granted by the Montana legislature. Mont. Code Ann. § 69-3-101, *et seq.* The rates set by the PSC through its rate-making policies must be at a level that allow a just compensation for any regulations imposed which impair the property interests of the utility company. *West Ohio Gas Co. v. Public Utilities Commission of Ohio,* 294 U.S. 63 (1935). Compliance with the Act and the accompanying regulation will mean that MWC will incur additional operating expenses. These expenses will be a part of the data presented by MWC when applying to the PSC for additional rate increases.

17. PSC Docket 89.6.23 was the first rate case filed by Mountain Water since the enactment of SB 28 into law.

18. Mountain Water sought to recover in PSC Docket 89.6.23 the $165,108 it actually had to pay over to its customers in compliance with SB 28 during the period January 1, 1988 through December 31, 1989.

19. The PSC, in its Orders 5449a and 5449b in PSC Docket 89.6.23 denied Mountain Water the recovery in rates of the $165,108 it actually had to pay over to its customers in compliance with SB 28 during the period January 1, 1988 through December 31, 1989 on the basis such recovery was barred by the general doctrine prohibiting retroactive ratemaking.

20. The PSC's Orders 5449a and 5449b entered in PSC Docket 89.6.23 are unreasonable and unlawful because:

a. They exceed the power of the PSC, as the PSC is not empowered to violate the rights of Mountain Water guaranteed to it under the Fifth and Fourteenth Amendments to the United States Constitution and Article II, Section 16 of the Montana Constitution;

b. They are based upon a mistake of law, as the PSC is estopped by its representations to the United States District Court;

c. They arbitrarily and unjustly fix rates contrary to the evidence in PSC Docket 89.6.23;

d. They represent a clear abuse of discretion.

21. Mountain Water is entitled to an order remanding PSC Docket 89.6.23 back to the PSC with instructions that it must recalculate Mountain Water's last approved rate so as to include, as an addition to those rates, the $165,108 paid over by Mountain Water to its customers in compliance with SB 28 for the period January 1, 1988 through December 31, 1989.

COUNT TWO

In the alternative to Count One, and without prejudice thereto, Mountain Water alleges as follows:

22. This is a petition for judicial review pursuant to the Montana Administrative Procedures Act (MAPA) §§ 2-4-701, *et seq.*, MCA.

23. Mountain Water realleges Paragraphs 2-19 and 21 above as if fully set forth herein.

24. Mountain Water Company is a regulated utility under the jurisdiction of the PSC, pursuant to §§ 69-3-101, *et seq.*, MCA, and is aggrieved by the issuance of Orders 5449a and 5449b in PSC Docket 89.6.23. Venue is properly in Lewis and Clark County as the PSC is found in that county.

25. The substantial rights of Mountain Water have been prejudiced because the provisions of the orders referred to above are:

a. Clearly erroneous in view of the reliable probative and substantial evidence of the whole record;

b. Arbitrary and capricious;

c. Entered upon a mistake of law;

d. A violation of the rights guaranteed Mountain Water by the Fifth and Fourteenth Amendments of the United States Constitution and Article II, Section 16 of the Montana Constitution.

WHEREFORE, Mountain Water prays for relief as follows:

1. For a decree of this Court that Orders 5449a and 5449b entered in PSC Docket 89.6.23 are unlawful, as complained of above;

2. Upon entry of the Court's decree, an order remanding PSC Docket 89.6.23 back to the PSC for the entry of a Commission order which conforms to the Court's decree;

3. Upon entry of the Court's decree, a permanent injunction order enforcing the terms of the Court's decree;

4. For such other and further relief as may be equitable and just.

DATED July 26, 1990.

HUGHES, KELLNER, SULLIVAN & ALKE

By John Alke
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MONTANA FIRST JUDICIAL DISTRICT COURT,
LEWIS & CLARK COUNTY

* * *

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff and Petitioner, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL, Defendants and Respondents.	NO. CDV 90-607 OPENING BRIEF

FACTS

This case is an appeal of two orders (Orders 5449a and 5449b) issued by the Montana Public Service Commission (Commission) in a rate case (PSC Docket 89.6.23) filed by the Plaintiff and Petitioner Mountain Water Company. However, the primary issues on this appeal do not flow from the esoterica of public utility ratemaking. They are instead rooted in the enactment into law of Senate Bill

28, from the 1987 legislative session, and the subsequent challenge to the constitutionality of that enactment in federal court.

There are only two major privately owned water utilities in Montana, the Butte Water

* * *

III. THE COMMISSION'S REFUSAL TO PERMIT THE RECOVERY OF THE $165,000 IN COSTS INCURRED BY MOUNTAIN WATER IN COMPLYING WITH SENATE BILL 28 IS A PROHIBITED TAKING BARRED BY THE FIFTH AND FOURTEENTH AMENDMENTS TO THE UNITED STATES CONSTITUTION AND ARTICLE II, SECTION 29 OF THE MONTANA CONSTITUTION.

Mountain Water's takings claim in the federal court litigation is a facial challenge to Senate Bill 28. This appeal now raises an additional takings question. Does the Commission's refusal to permit Mountain Water the recovery of the costs it incurred in complying with Senate Bill 28 constitute a prohibited taking, even if it is assumed that the statute itself may survive Mountain Water's facial challenge? In other words, does the Commission's application of Senate Bill 28 in the context of PSC Docket 89.6.23 constitute a taking barred by the United States or Montana Constitutions?

It is not necessary to reach the federal question, on an as applied basis, as controlling Montana case law specifically holds that it is a taking under the Montana Constitution, ***McTaggart v. Montana Power Company***, *184 Mont. 329, 602 P.2d 992 (1979).* The facts of the ***McTaggart*** case

are quite similar to the instant case, although the case did not arise in the context of a rate case. In *McTaggart,* the challenged state statute required an electric utility to relocate its power lines when requested to do so by an owner of agricultural lands. The statute then specified that the utility had to bear one-half of the cost of the requested relocation. The Montana Supreme Court correctly held that a statute requiring a utility to underwrite the expenses of another was a prohibited taking, *McTaggart at 336.*

Unlike the *McTaggart* case, in which the statute specified a 50-50 split of the costs incurred by the utility in complying with the statute, Senate Bill 28 is silent as to who bears the expense of compliance. However, the Commission argued to the United States District Court that Senate Bill 28 contemplated that the required compensation would be provided through the ratemaking process. The Commission's refusal to allow Mountain Water to recover through rates the $165,000 in out-of-pocket expenses which it incurred in complying with Senate Bill 28 is, then, an unconstitutional application of the statute, and barred by Article II, Section 29 of the Montana Constitution.

The Commission has judicially admitted that its refusal to permit Mountain Water to recover its cost of complying with Senate Bill 28 in rates is a prohibited taking. In a January 29, 1988 brief to the United States District Court, at page 13, the Commission stated:

> But the mere fact that a regulatory commission may disallow recovery of legitimate expenses associated with the statutory requirement does

not render the statute to be complied with inherently unconstitutional. With respect to S.B. 28, the potential exists that the PSC could disallow compliance costs which could contribute to a finding of an unconstitutional "taking." But in such a case it would be the action of the PSC that would comprise the unconstitutional "taking"; SB 28 itself would not thereby be rendered unconstitutional. (Emphasis added.)

CONCLUSION

Mountain Water is entitled to a decree of this Court that Orders 5449a and 5449b entered in PSC Docket 89.6.23 are unlawful as described above, and remanding the docket back to the Commission for a decision in accordance with the Court's decree. Further, Mountain Water is entitled to a permanent injunction order enforcing the terms of the Court's decree.

DATED November 2, 1990.

HUGHES, KELLNER, SULLIVAN & ALKE

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CERTIFICATE OF SERVICE BY MAIL

I hereby certify that a true and correct copy of the foregoing **OPENING BRIEF** has been mailed, postage prepaid, upon the following persons on **November 2, 1990:**

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ATTORNEYS FOR PLAINTIFF
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MONTANA FIRST JUDICIAL DISTRICT, LEWIS AND CLARK COUNTY

* * *

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION and MONTANA CONSUMER COUNSEL, Defendants/Respondents.	)	NO. CDV 90-607 REPLY BRIEF (Filed Jan. 22, 1991)

INTRODUCTION

Mountain Water submitted its opening brief in this litigation on November 2, 1990. On November 26, 1990, the Ninth Circuit Court of Appeals issued its decision in the parallel federal court litigation, ***Mountain Water Company v. Montana Department of Public Service Regulation, Montana Public Service Commission,*** *No.*

88-4097. That decision was included as Appendix H of the extensive appendices submitted by the Montana Public Service Commission (Commission). Although the Ninth Circuit sustained § 69-4-511, MCA, (Senate Bill 28) against Mountain Water's facial challenge, it did so in such a way as to obligate this Court to rule in favor of the Mountain Water Company in this litigation. Mountain Water files this brief in response to the answer briefs filed by the Commission and the Montana

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retroactive ratemaking.

IV. Senate Bill 28, as applied by the Commission in this case, violates the Fifth and Fourteenth Amendment to the United States Constitution and Article II, Section 17 of the Montana Constitution.

A. Senate Bill 28, as applied by the Commission in this case, constitutes an impermissible taking for a nonpublic use.

The Fifth Amendment, by its own terms, specifically limits the power of the sovereign to take private property to a taking for a public use. One of the basic tenets of our jurisprudence is the condemnation of any law " . . . that takes property from A and gives it to B . . . ," ***Calder v. Bull***, *3 U.S. 386, 388 (1798)*. That principle retains its vitality today in modern Fifth Amendment jurisprudence, ***Hawaii Housing Authority v. Midkiff***, *467 U.S. 229, 245 (1984)*:

> The State of Hawaii has never denied that the Constitution forbids even a compensated taking of property when executed for no reason other

> than to confer a private benefit on a particular private party. A purely private taking could not withstand the scrutiny of the public use requirement; it would serve no legitimate purpose of government and would thus be void.

The limitation on the power of the sovereign to take private property is so strict that it applies, as noted above, even if there is adequate compensation for the taking. In accord, ***Missouri Pacific Railway Company v. Nebraska, 164 U.S. 407 (1896).***

Senate Bill 28 takes money from Mountain Water and gives it to either the Mountain Water customer who had to repair his service line, or to an insurance carrier which provided coverage to a Mountain Water customer against the deterioration of his service line.[9] Not only do existing water service lines remain the private property of the individual Mountain Water customer under § 69-4-511, MCA, but all new service lines will still have to be constructed by the individual customers to be served by them. All of the incidents of ownership, including the right of dominion and control, remain with the individual Mountain Water customer. Thus, any decision relating to the repair of the services lines (if, when, how much to spend) remain the sole prerogative of the individual customer.

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[9] Many Mountain Water customers have homeowners insurance which cover their water service lines. The Commission has determined that Mountain Water owes the insurer reimbursement under the statute. See Appendix "A" attached to this brief.

The Fifth Amendment prohibits any regulatory scheme, or application of a regulatory scheme, which takes the property of one person and confers it as a private benefit upon someone else. The United States Supreme Court has routinely struck down such attempted redistributions as being in violation of the Fifth Amendment. In ***Thompson v. Consolidated Gas Utilities Corp.*** *300 U.S. 55 (1936)* the State of Texas issued a gas proration order which required the plaintiffs to reduce their production of their own gas and buy gas from other producers in the field. The plaintiff utilities had constructed extensive gathering lines and pipelines to take their production to distant markets, which they had contractually secured. The remaining producers had neither pipelines to transport their gas, or a market for it, and had to either shut in their oil production or flare their natural gas. The unarticulated purpose of the proration order, which reduced the plaintiffs' production below their market requirements, was to force them to satisfy the remainder of their market requirements by purchasing gas from the other producers. The order effectively gave the other producers access to plaintiffs' markets and pipeline facilities. Although the Supreme Court conceded that the State of Texas had the unquestioned power to prevent the waste of natural gas, it held that the state could not use its police power, consistent with the Fifth Amendment, to effectively take the property interests of one set of producers and bestow it upon another set of producers. In accord, ***Interstate Commerce Commission v. Oregon and Washington Railroad Company,*** *288 U.S. 14 (1932);* ***Chicago, St. Paul, Minneapolis, Omaha Railway Company v. Holmberg,*** *282 U.S. 162 (1930);* ***Delaware,***

Lackawanna and Western Railroad Company v. Town of Morrison, *276 U.S. 182 (1927).* Montana incorporates the same public purpose requirement in Article II, Section 17, of its constitution, § 70-30-101, MCA, ***McTaggart v. Montana Power Company,*** *184 Mont. 329, 333, 602 P.2d 992 (1979);* ***Spratt v. Helena Power Transmission Company,*** *37 Mont. 60, 94 P. 631 (1908).*

The Commission's application of Senate Bill 28 in this case destroys the public purpose hypothesized by the Ninth Circuit in the parallel federal court litigation, and constitutes an impermissible taking for a nonpublic use in violation of the Fifth and Fourteenth Amendment of the United States Constitution, and Article II, Section 17 of the Montana Constitution.

B. Senate Bill 28, as applied by the Commission in this case, confiscates the private property of Mountain Water without just compensation.

Although the Ninth Circuit rejected Mountain Water's facial challenge to Senate Bill 28, it did so by reserving a critical constitutional question until this proceeding, *Mountain Water, supra at 14550:*

> Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order, but not the statute, unconstitutional.

It is an uncontrovertible fact in this litigation that Orders 5449a and 5449b refuse to provide Mountain Water with any compensation for the transfers of money that it was compelled to make in 1988 and 1989. The Respondents

argue that it is inappropriate to look at how the Commission treated Senate Bill 28 expenses on a stand-alone basis, and suggest that such a requirement would force the Commission to examine every expense incurred by Mountain Water in the same fashion.[10] The money that Mountain Water must give away in compliance with Senate Bill 28 is an indisputably unique expense. It is the only expense which Mountain Water incurs in complying with a statutory provision which was *specifically found* to constitute a taking, *Mountain Water, Supra at 14547*:

> We agree with the district court and the parties in this case that by requiring Mountain Water to reimburse its customers for repairs to their privately-owned service lines, the liability statute effects a taking of Mountain Water's property.

Given that SB 28 takes the private property of Mountain Water and gives it to select Mountain Water customers, it was incumbent upon the Commission to insure that its rate order specifically provided Mountain Water full recovery of its costs of complying with the statute. The only way to make that assurance is to examine the Commission's treatment of SB 28 expenses on a stand-alone basis.

The Commission's refusal to permit Mountain Water the recovery of the $165,000 it gave to its customers in compliance with Senate Bill 28 forces Mountain Water to absorb $165,000 of its customers' expenses. The Montana Supreme Court has already ruled that it is an uncompensated taking to require a utility to absorb such expenses, ***McTaggart v. Montana Power Company, supra.*** Although the Commission tries to distinguish ***McTaggart*** by claiming it was "a typical

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[10] Commission Brief, p. 13; footnote 13, MCC brief, p. 16.

imminent [sic] domain case"[11] that assertion is untrue. Neither party in the *McTaggart* case was attempting to acquire property from the other. The sole issue was whether the State of Montana could require a utility to bear a portion of the expense a landowner would incur in moving power lines to install a sprinkler irrigation system. To be sure the statutes at issue in *McTaggart* "sound an imminent [sic] domain", *McTaggart, supra at p. 337.* But, so does the statute at issue in this case. The Ninth Circuit specifically found that SB 28 constituted a taking.

CONCLUSION

Mountain Water is entitled to an order of this Court remanding PSC Docket 89.6.23 back to the Commission with instructions that the Commission must allow Mountain Water the full recovery of the money it has given to its customers in compliance with Senate Bill 28, including the $165,000 it paid out in 1988 and 1989.

DATED January 22, 1991.

HUGHES, KELLNER, SULLIVAN & ALKE

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[11] Commission Brief, p. 18.

CERTIFICATE OF SERVICE BY MAIL

I HEREBY CERTIFY that a copy of the foregoing **REPLY BRIEF** was served upon the following by mailing a true and correct copy thereof on **January 22, 1991,** addressed as follows:

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John Alke
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NO. 91-446

* * *

IN THE SUPREME COURT OF
THE STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY,
a Montana corporation,

Plaintiff and Respondent,

-vs-

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL,

Defendants and Appellants.

BRIEF OF PLAINTIFF-RESPONDENT MOUNTAIN WATER COMPANY

On Appeal From The
District Court of the First Judicial District
of the State of Montana, In and For the
County of Lewis and Clark
Cause No. CDV 90-607

APPEARANCES:

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The MCC suggests that *McTaggart* can be factually distinguished from the instant case. The suggested basis for distinction was that *McTaggart* was an "eminent domain" case and required the utility pay for something it had already lawfully obtained.[29] *McTaggart* cannot be successfully distinguished on the basis it was an "eminent domain" case, as § 69-4-511, **MCA** has already been adjudicated as a taking. The second suggested distinction is equally untenable. The statute at issue in *McTaggart* required the petitioning land owner to *give* the utility an alternative right-of-way. It was the cost of relocating the utility's facility to the new right-of-way which was at issue. The money paid out by the utility to comply with the statute in *McTaggart*, is indistinguishable from the money Mountain Water had to pay out in compliance with § 69-4-511, MCA.

V. THE FIFTH AND FOURTEENTH AMENDMENTS OF THE UNITED STATES CONSTITUTION BAR THE ATTEMPTS OF THE PSC AND MCC TO DENY MOUNTAIN WATER THE RECOVERY OF THE MONEY IT PAID IN COMPLIANCE WITH § 69-4-511, MCA.

The attempted refusal of the PSC to permit Mountain Water to recover in rates the $165,108 it paid out in compliance with § 69-4-511, MCA would have resulted in an application of the statute which violated the Fifth and Fourteenth Amendments to the United States Constitution. The attempted action of the PSC would have

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[29] MCC brief, pp. 15-16.

destroyed the public purpose behind the statute and confiscated the private property of Mountain Water.

This Court has the advantage of being the second court to visit these issues. It has before it the prior adjudication of the Ninth Circuit that § 69-4-511, MCA constitutes a taking of the private property of Mountain Water. All that remains for this Court is to take that holding and to complete the analytical process begun by the Ninth Circuit.

The Fifth Amendment to the United States Constitution provides in pertinent part:

> . . . nor shall private property be taken for public use, without just compensation.

The provisions of that amendment are applicable to the State of Montana, and its agencies, by virtue of the Fourteenth Amendment of the United States Constitution.[30] The protection of the Fifth Amendment extends to all property, whether real or personal, tangible or intangible, ***Ruckelshaus v. Monsanto,*** *467 U.S. 986 (1983);* ***Armstrong v. U.S.,*** *364 U.S. 40 (1960).* Mountain Water lawfully earned, under prior rate orders of the PSC, the money which it had to give to its customers under the statute. Those earnings are its private property, ***Board of Public Utility Commissioners v. New York Telephone Company,*** *271 U.S. 23 (1925).* The money earned by Mountain Water is entitled to the same Fifth Amendment protection as any other property interest, ***Webbs*** [sic] ***Fabulous Pharmacies, Inc. v. Beckwith,*** *449 U.S. 155 (1980).*

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[30] ***Chicago, Burlington and Quincy RR v. Chicago,*** *166 U.S. 226, 239 (1897).*

The Fifth Amendment, by its own terms, specifically limits the power of the sovereign to take private property to a taking for a public use. One of the basic tenets of our jurisprudence is the condemnation of any law " . . . that takes property from A. and gives it to B. . . . ," ***Calder v. Bull,*** *3 U.S. 386, 388 (1978).* That principle retains its vitality today in modern Fifth Amendment jurisprudence, ***Hawaii Housing Authority v. Midkiff,*** *467 U.S. 229, 245 (1984):*

> The State of Hawaii has never denied that the Constitution *forbids even a compensated taking* of property when executed for no reason other than to confer a private benefit on a particular private party. A purely private taking could not withstand the scrutiny of the public use requirement; it would serve no serve no legitimate purpose of government and would thus be void). (Emphasis added.)

The limitation on the power of the sovereign to take private property is so strict that it applies, as noted above, even if there is adequate compensation for the taking. In accord, ***Missouri Pacific Railway Company v. Nebraska,*** *164 U.S. 407 (1896).*

Mountain Water challenged § 69-4-511, MCA in federal court as a taking for a non-public use. The Ninth Circuit rejected that challenge in large part because of the representations of the PSC that Mountain Water would be compensated in rates for the taking worked by the statute, ***Mountain Water,*** *supra, at 599-600.*

> Moreover, the liability statute may serve the additional public purpose of redistributing the cost of service line repairs. Prior to enactment of

> the liability statute, customers of privately-owned water utilities bore sole financial responsibility for service line repair costs. The liability statute not only shifts this financial burden from the customer to privately-owned utilities, but also redistributes the financial burden among all the customers of the utility. The statute accomplishes this redistribution by forcing privately-owned utilities to request higher rates to cover their expenses in reimbursing customers whose service lines require repair. By paying these higher rates, all the customers of a privately-owned utility share in the cost of repairing some of the customers' service lines. *The liability statute thus redistributes the cost of service line repair from individual customers to all customers through higher rates, and it [sic] employees the privately-owned utility as the agent for that redistribution.* This possible redistribution purpose is also a public use, and we defer to the wisdom of the legislature in requiring that public use of Mountain Water's private property. (Emphasis added.)

The PSC decision in Docket 89.6.23 would have destroyed the basis used by the Ninth Circuit in rejecting Mountain Water's challenge. If the money Mountain Water is forced to pay out under the statute is not reflected in the rates Mountain Water is authorized to charge its customers, Mountain Water is no longer an "agent" redistributing the cost of water service line repair to all customers, but the unwilling source of a state compelled transfer of wealth.

The State of Montana cannot, consistent with the Fifth and Fourteenth Amendments to the United States Constitution, simply decide that Mountain Water should

pay its' customers bills, *Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 416 (1922)*:

> In general it is not plain that a man's misfortunes or necessities will justify a shifting the damage to his neighbors [sic] shoulders.

The fact that Mountain Water is a public utility as defined by Montana law, and subject to rate regulation by the PSC, does not change the analysis. The Fifth Amendment prohibits any regulatory scheme, or application of a regulatory scheme, which effectively takes the property of one person and confers it as a private benefit upon someone else. The United States Supreme Court has routinely struck down such attempted redistributions as being in violation of the Fifth Amendment.

In *Thompson v. Consolidated Gas Utilities Corp., 300 US. 55 (1936)* the State of Texas issued a gas proration order which required the plaintiffs to reduce their production of their own gas and buy gas from other producers in the field. The plaintiff utilities had constructed extensive gathering lines and pipelines to take their production to distant markets, which they had contractually secured. The remaining producers had neither pipelines to transport their gas, or a market for it, and had to either shut in their oil production or flare their natural gas. The unarticulated purpose of the proration order, which reduced the plaintiffs' production below their market requirements, was to force them to satisfy the remainder of their market requirement by purchasing gas from the other producers. The order effectively gave the other producers access to plaintiff's markets and pipeline facilities. Although the Supreme Court conceded that the State of Texas had the unquestioned power to prevent the

waste of natural gas, it held that the state could not use its police power, consistent with the Fifth Amendment, to effectively take the property interests of one set of producers and bestow it upon another set of producers.

In *Interstate Commerce Commission v. Oregon and Washington Railroad Company, 288 U.S. 14 (1932)* the Interstate Commerce Commission, at the request of the State of Oregon, ordered the railroad to complete a previously planned route across central Oregon. The Southern Pacific Railroad, and the Union Pacific Railroad, of which the plaintiff railroad was a subsidiary, had planned the central route across Oregon as part of their unified operations, before an anti-trust decree required the separation of their operations. After the separation, neither railroad system, individually, had any interest in completing the central line. Although railroad property is dedicated to public service, just as utility property, the Supreme Court held the sovereign had no power to order such a deployment of assets.

The case of *Chicago, St. Paul, Minneapolis, Omaha Railway Company v. Holmberg, 282 U.S. 162 (1930)* involved an order of the State of Nebraska requiring the railroad to install an underground cattle pass beneath its tracks, the majority of the cost of such construction to be borne by the railroad. A farmer owned the land on both sides of the tracks and there was a farm crossing at grade, in the corner of the farm. The farmer petitioned the state railroad commission for an order requiring the installation of the underground cattle pass on the basis that the utilization of the existing grade crossing required him to drive his cattle through his cultivated fields. The state's regulatory power over railroads, including the power to

require installation of a grade crossing, was unquestioned. But, again the utilization of that power to provide private benefit was stricken as a violation of the Fifth Amendment.

In *Delaware, Lackawanna, and Western Railroad Company v. Town of Morristown, 276 U.S. 182 (1927)*, a town ordered a railroad company to permit taxi cabs access to the railroad's private station grounds. The railroad company had entered into an agreement with the town to elevate the tracks, thereby eliminating the need for grade crossings. As part of the agreement, the town agreed to construct a new street extending to the station grounds. In turn, the railroad agreed to provide limited public access to the station grounds. Due to congestion on the station grounds caused by cabbies competing for fares, the railroad company granted a particular cab company an exclusive franchise to serve the station grounds providing he stockpiled sufficient cars at the station to service its patrons. The City passed one ordinance which prohibited stockpiling of the cars by the franchisee, and another declaring the area formally utilized by the franchisee as a public hack stand. Again, the forced contribution for the private benefit of the competing cabbies was stricken as a violation of the Fifth Amendment.

The PSC and MCC essentially contend that Mountain Water's compensation for the taking worked by § 69-4-511, MCA is a matter vested in the discretion of the PSC. That contention is untenable. Once the federal courts found that a taking occurred, compensation was obligatory under the Fifth and Fourteenth Amendments to the United States Constitution. The PSC and MCC assert that the recent U.S. Supreme Court holding in

Duquesne Light Company v. Barasch, 488 U.S. 299, 109 S. Ct. 609 (1989) supports their position. It does not. The statute at issue in *Duquesne* was a rate making standard imposed upon the Pennsylvania commission by the Pennsylvania legislature. In the instant case, the statute at issue doesn't even peripherally address rate making, or rate making standards. Of critical significance, the Supreme Court in *Duquesne* specifically held that the state statute at issue did *not* constitute a taking, *id.* at 612:

> Pennsylvania law required that rates for electricity be fixed without consideration of a utility's expenditures for electrical generating facilities which were planned but never built, even though the expenditures were prudent and reasonable when made. The Supreme Court of Pennsylvania held that such a law did not take the utilities' property in violation of the Fifth Amendment to the United States Constitution. We agree with that conclusion.

In contrast, the statute of bar has been specifically adjudicated to be a taking.

The majority in *Duquesne* held it was very difficult to define the constitutional limits of rate making, *id. at 616:*

> If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments. As has been observed, however, "[h]ow such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question."

It provided the following rationale for the difficulty. *id. at 619:*

> The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties.

The only constitutional standard it could articulate for rate orders was that they had to be "just," ***id.*** *at 615* and "reasonble," ***id.*** *at 617*. Difficult economic concepts of rate making are not at issue, and not a factor in the instant case. The State of Montana, through its enactment of § 69-4-511, MCA, has taken the private property of Mountain Water and given it to certain of its customers. No complex economic theory has to be applied to determine the value of the money taken. It was neither just or reasonable for the PSC to deny Mountain Water the recovery in its rates of the money it was compelled to give to its customers in compliance with the statute.

The MCC suggests that the PSC decision in Docket 89.6.23 did not take any property of Mountain Water because the PSC "found" that Mountain Water had actually recovered its cost of compliance.[31] Both the argument and the "finding" are totally at odds with the actual decision of the PSC in Docket 89.6.23. The PSC makes rates on the basis of an historic test year. The historic test year used in the docket was calendar year 1988, the *first* year in which Mountain Water had to pay money to its customers under compulsion of the statute. The PSC *specifically found* that Mountain Water was suffering a revenue deficiency of $414,727 in the test year, and

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[31] See MCC brief, pp. 7-8, 13-14.

accordingly authorized a rate increase of $414,727.[32] The attempt of the PSC to justify its unreasonable action was completely contradicted by its own decision.

CONCLUSION

The District Court decision should be affirmed.

Respectfully submitted the 20th day of March, 1992.

HUGHES, KELLNER, SULLIVAN & ALKE

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ATTORNEYS FOR MOUNTAIN WATER COMPANY

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[32] Finding of Fact 76, Order 5449a (Document 10, Appellants' Joint Appendix, pp. 29-30).

IN THE SUPREME COURT OF THE
STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY, a Montana corporation, Plaintiff and Respondent, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL, Defendants and Appellants.	NO. 91-446 PETITION FOR REHEARING (Filed Jul 30, 1992)

MOUNTAIN WATER COMPANY, Respondent in the above-captioned matter, respectfully petitions the Court, pursuant to M. R. App. P. 34, for rehearing of the above-captioned matter. The grounds for the petition are that the Court has, in rendering its decision, overlooked facts material to the decision, and neglected to adjudicate all of the issues before it.

I. MATERIAL FACTS, CRITICAL TO THE DECISION, WERE OVERLOOKED BY THE COURT

To comply with the provisions of § 69-4-511, MCA, Mountain Water had to give away $165,108.00 of its money in 1988 and 1989. The federal courts have specifically adjudicated the statute a taking of the private property of Mountain Water Company, ***Mountain Water***

Company v. Montana Department of Public Service Regulation, 919 F.2d 593 (9th Cir. 1990). The statute survived Mountain Water's takings challenge in federal court because the Montana Public Service Commission (Commission) represented to the federal courts that Mountain Water would be compensated in rates for the taking. This Court's opinion, dated July 21, 1992, reverses a district court ruling, and upholds a Commission decision which denied Mountain Water the recovery of the first $165,108 it had to give away under compulsion of the statute. The Court's decision produces a highly unjust and unreasonable end result.

To explain the highly unjust and unreasonable end result, the Court determined in its opinion that the end result was really the fault of the Mountain Water Company, Slip Op. at 4-5:

> MWC was aware that the Montana legislature enacted § 69-4-511, MCA. Prior to the law taking effect on October 1, 1987, MWC could have applied to the PSC to recover the utility costs for 1988 and 1989 under § 69-4-511, MCA.

This part of the Court's opinion appears to have been drawn from the briefs of the Commission[1] and the Montana Consumer Counsel (MCC).[2] What the Court erroneously believed was fact was in reality the self-serving argument of the Commission and the MCC, argument which was contradicted by the clear language of the Commission's own administrative rules, contradicted by the MCC's own assertions to the Commission in PSC

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[1] Commission Brief, pp. 4, 23-25.

[2] MCC Brief, pp. 6-7.

Docket 87.6.30, and contradicted by the Commission's own finding of facts in the administrative order now under judicial review.

The Court's opinion erroneously asserts that the Commission makes rates on the basis of prospective costs, Slip Op. at 4:

> In Montana, public utility rates are set to match utility costs during the period that rates are in effect.

In fact, the Commission makes rates on the basis of a *dated historic test year,* ARM 38.5.106:

> The statement of the cost of service shall contain an analysis of system costs as reflected on the filing utility's books for a *test period consisting of 12 months actual experience ending no earlier than 9 months prior to the date of filing* of the data required by ARM 38.5.101 and 38.5.105, unless good cause be shown. This analysis shall include the return, taxes, depreciation, and operating expenses, and an allocation of such costs to the services rendered. The information submitted with the statement shall show the data itemized below for the test period, as reflected on the books of the filing public utility. Any proposed adjustments to book costs shall be explained in writing. Such adjustments shall be shown separately and shall be fully supported, including schedules showing their derivation, where appropriate. However, *no adjustments shall be permitted unless known with certainty and measurable with reasonable accuracy at the time of the filing.* No adjustment will be entertained unless it will become effective within 12 months of the last month of the test

> period as used in this section. (Emphasis added.)

Section 69-4-511, MCA, was enacted in 1987 and became effective on October 1, 1987. The first time that Mountain Water had " . . . a test period consisting of 12 months actual experience ending no earlier than 9 months prior to the date of filing . . . " which included any cost of complying with § 69-4-511, MCA, was in 1989, after 1988 data was available. Accordingly, it made its first filing to recover its cost of complying with § 69-4-511, MCA, in the 1989 rate filing at issue, based upon 1988 historic costs.[3]

ARM 38.5.106 does permit a utility to incorporate adjustments to historic test year data which are "known with certainty and measurable with reasonable accuracy *at the time of filing.*" *Id.*[4] However, Mountain Water has no way of knowing what demands its customers will make under § 69-4-511, MCA, until the demands are actually made. Mountain Water's costs of complying with the

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[3] The application was not heard until January of 1989. At that time, Mountain Water also provided the Commission with the total of the money paid out in compliance with § 69-4-511 in 1989.

[4] The classic example of a change which meets the standard is a change in labor expense under a collective bargaining agreement. For example, if Mountain Water had had a collective bargaining agreement which raised its labor cost between the end of the 1988 test year and its 1989 rate filing, it would have been permitted to recalculate the test year labor expense to reflect the higher wage rate under the collective bargaining agreement. The new wage rate is "known with certainty and measurable with reasonable accuracy at the time of filing" because the amount of the increase is specified in the bargaining agreement.

statute is unlike its other costs of doing business. It cannot plan for them, it cannot budget for them, it cannot estimate them. If its customers submit to it in a given year, $50,000 in bills for payment, Mountain Water must pay out $50,000. If its customers submit to it in a given year $250,000 in bills for payment, Mountain Water must pay out $250,000. The Commission specifically found, in the administrative order now under judicial review, Finding of Fact 41-42, Order 5449a:

> 41. MWC asserted that SB 28 expenses are not subject to the control of the utility and are expenses that are presently subject to significant variation. In support of this argument MWC drew the Commission's attention to the difference between the 1988 and 1989 expenses for this item. The Commission is persuaded by MWC that at the present time SB 28 expenses are volatile and not subject to the control of the utility.
>
> 42. Because of the volatility of the expense MWC proposed the implementation of a tracking mechanism for SB 28 expenses so that it could be assured that on a prospective basis it would be fully compensated for these costs. The Commission agrees in principle with MWC's proposal to implement a tracker. . . .

It was impossible for Mountain Water to comply with the Commission's rule 38.5.106 until calendar year 1988 had ended.

It is that impossibility which makes the Appellants' position, that Mountain Water should have made a 1987 rate filing, as had Butte Water Company, so grotesquely unfair. Butte Water Company did make a filing in 1987

and simply included a large number as an estimate of its cost of complying with § 69-4-511, MCA. The MCC, who now prevails in this action under the Court's opinion, vehemently protested the action of both the Butte Water Company, and the Commission decision which approved it, as a flagrant violation of the plain language of the Commission's own administrative rules, MCC Motion for Reconsideration in PSC Docket 87.6.30.[5]

> . . . MCC believes that the Commission was incorrect in finding the expenses that will be incurred by the Butte Water Company (Company) to make the repairs required by SB 28 are known and measurable changes . . . By disregarding the phrase "at the time of filing" the orders have distorted the rule [ARM 38.5.106] beyond recognition . . . MCC does not agree that the revised estimates provided an adjustment that was measurable with reasonable accuracy, as evidenced by the wide variation between the original and revised estimates . . . *The result of the orders is simply absurd. The Commission could just as well say that up is down and on is off as to say that the Company's SB 28 adjustment is a known and measurable change* (Emphasis added.)

The MCC correctly pointed out in that administrative proceeding that the *only* way to comply with both the requirements of § 69-4-511, MCA, and ARM 38.5.106, was to capitalize the initial cost of complying with the statute, file a rate case *after* the necessary historical experience was obtained, and amortize the capitalized amount.[6] That

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[5] Appendix D to Mountain Water's Answer Brief, attached to this petition.

[6] *Id.*.

was *exactly* what Mountain Water did in the case now at issue.[7]

The only way this Court's factual determination that Mountain Water could have avoided the unjust and unreasonable result of the Court's opinion, by making a 1987 rate filing, would be true, is if Mountain Water knew, in 1987, that the Commission would violate its own administrative rules, over the vehement objection of the MCC. Even after the Butte Water Company case was decided, there was no assurance that the Commission would again violate its rules for the benefit of Mountain Water Company. In fact, in the administrative order now under judicial review, the Commission made it clear that its decision in Butte Water Company case could *not* be relied upon as precedent for Mountain Water, Finding of Fact 37, Order 5449a:

> The financial circumstances of MWC and Butte Water are different, and the Commission expresses no opinion on whether the treatment for Butte Water SB 28 expenses would have been appropriate for MWC.

The end result of this Court's opinion, if not changed on rehearing, is to financially punish Mountain Water for complying both with the provisions of § 69-4-511, MCA, and ARM 38.5.106. Such an end result is highly unjust and highly unreasonable. The Court should rehear this

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[7] The only difference was that Mountain Water proposed to capitalize both actual 1988 and 1989 compliance costs. Its 1989 rate filing, based upon historic test year 1988, was not even heard until 1989.

appeal so that its constitutional ruling reflects the actual facts of the case.

II. THE COURT NEGLECTED TO ADJUDICATE ALL OF THE ISSUES BEFORE IT

Mountain Water is entitled, on judicial review, to consideration not only of its constitutional claims, § 2-4-704(2)(a)(i), MCA, but its claim that the Commission's decision to apply the general rule against retroactive ratemaking to the facts of this particular case was arbitrary and capricious, § 2-4-704(2)(a)(vi), MCA. The District Court ruled only on the constitutional issue, holding that the Commission's decision violated the Fifth Amendment to the United States Constitution. This Court reversed the District Court holding, but failed to address Mountain Water's claim that the application of the general rule under the particular facts of this case was arbitrary and capricious.

The Court's oversight is significant. Its opinion only addresses what it perceives to be the constitutional limits of the Commission's power under the Fifth Amendment to the United States Constitution and Article II, Section 29 of the Montana Constitution. It does not address whether the Commission's decision was reached in a manner which was not arbitrary and capricious.

The Court held on this appeal, in accordance with its earlier decision in ***City of Helena v. Montana Department of Public Service Regulation,*** *194 Mont. 173, 634 P.2d 192 (1981),* that any application of the general rule against retroactive ratemaking was a "policy" decision, Slip. Op. at 4:

> The PSC admitted during the course of the federal litigation that § 69-4-511, MCA was a taking and that Mountain Water would be compensated through ratemaking.
>
> However, in making that admission, the PSC did not waive the application of the *policies* involved in ratemaking. (Emphasis added.)

Once the Court held that an application of the general rule was a policy decision for the Commission, Mountain Water was entitled, as of right under § 2-4-704(2)(a)(vi), MCA, to a judicial consideration of whether the policy decision rendered on the facts of this case was rendered in a manner which was arbitrary or capricious. (It would be circular reasoning to hold that the decision to apply the general rule against retroactive ratemaking in this case was not arbitrary and capricious because of the general rule against retroactive ratemaking.)

Ratemaking is not supposed to be a game. It is supposed to be conducted in a fair and evenhanded manner and produce a fair and evenhanded result, ***Great Northern Utilities Co. v. Public Service Commission,*** *88 Mont. 180, 223, 293 P.294 (1930):*

> Can it be said that the "arrangement" intended by the Act of the legislature in question was the "taking advantage of the public in an unlawful way?" We think not. *The purpose, as hereinbefore stated, is to determine a price which shall be just and reasonable to all concerns – the Utility as well as the consumer.* (Emphasis added.)

And again in ***Tobacco River Power Company v. Public Service Commission,*** *109 Mont. 521, 529, 98 P.2d 886 (1940):*

> The law is well settled in all jurisdictions, including Montana that rates must be just and reasonable, and likewise the return to the utility company on its investment and for service rendered must be fair, just and reasonable. (Citations omitted.) No great difficulty should be experienced in determining fair value of the property of the utility company *and just and reasonable rates which may be charged if both parties to a proceeding to determine the ultimate facts are candid, reasonable and fair with each other.* (Emphasis added.)

When the Commission decided to disallow the 1988 and 1989 compliance costs incurred by Mountain Water, it held that it was doing so because of the general rule against retroactive ratemaking. The Commission did not explain why its application of the general rule against retroactive ratemaking had to be applied to the facts of this particular case to achieve a just and reasonable end result. The Commission's decision does not protect the Mountain Water customer from unreasonable expenditures incurred by the Company. The expenditures were incurred under compulsion of Montana law. The Commission's decision was not necessary to prevent Mountain Water from being unjustly enriched at ratepayer expense. All Mountain Water is seeking is the *promised return,* in its rates, of the money it had to give away under compulsion of Montana law.

The Commission's failure to explain why it was appropriate to apply the general rule against retroactive ratemaking to the facts of this case puts the Court in a very awkward position. Unless the Court is to engage in circular reasoning, and hold that the mere existence of the

general rule is, in and of itself, justification for applying the general rule to the facts of this case, there is no basis for determining that the Commission's decision was not arbitrary and capricious. At a minimum, the Court should remand this matter to the Commission with instructions to explain why it was necessary to apply the general rule against retroactive ratemaking to the facts of this particular case in order to achieve a just and reasonable end result.

WHEREFORE, Mountain Water Company respectfully requests that the Court rehear this appeal, and after such rehearing, remand PSC Docket 89.6.23 to the Commission with appropriate instructions.

RESPECTFULLY SUBMITTED July 30, 1992.

HUGHES, KELLNER, SULLIVAN & ALKE

By /s/ John Alke
John Alke
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ATTORNEYS FOR RESPONDENT

CERTIFICATE OF SERVICE BY MAIL

I HEREBY CERTIFY that a copy of the foregoing **PETITION FOR REHEARING, OR, IN THE ALTERNATIVE, FOR CLARIFICATION OF OPINION** was served upon the following by mailing a true and correct copy thereof on **July 30, 1992,** addressed as follows:

MARY WRIGHT
MONTANA CONSUMER COUNSEL
34 WEST SIXTH
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ROBIN MCHUGH
PUBLIC SERVICE COMMISSION
1701 PROSPECT AVENUE
HELENA MT 59620

/s/ John Alke
John Alke

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * *

IN THE MATTER of the Application of the BUTTE WATER COMPANY for Authority to Increase Rates and Charges for Water Service to its Butte, Montana Customers	)))))	UTILITY DIVISION DOCKET NO. 87.6.30
IN THE MATTER of the Application of the BUTTE WATER COMPANY for Authority to Increase Rates and Charges for Water Service to its Anaconda, Montana Customers	)))))	UTILITY DIVISION DOCKET NO. 87.6.31

* * *

MOTION OF THE MONTANA CONSUMER COUNSEL FOR RECONSIDERATION OF ORDER NO. 5331 AND ORDER NO. 5332

The Montana Consumer Counsel (MCC) respectfully moves the Public Service Commission (Commission) for reconsideration of Order No. 5331 and Order No. 5332 in these dockets. Specifically, MCC asks that the Commission reconsider the portions of those orders dealing with service line repairs required by section 69-4-511, M.C.A. (S.B. 28). MCC believes that the Commission was incorrect in finding the expenses that will be incurred by the Butte Water Company (Company) to make the repairs required by S.B. 28 are known and measurable changes. These findings violate the Commission's own rules, and if

allowed to stand, will be a very poor precedent in future utility rate cases.

BACKGROUND

In its application, the Company asked the Commission to include in rates its estimated expenses for S.B. 28 repairs. Because the Company had no experience in this area, it obtained estimates for thawing frozen lines ranging from $12,000 to $60,000, and estimates for other repairs of $205,000 for the Butte Division. The Company witness conceded that the figures were estimates, and not as accurate as the Company would like.[1] The estimates for the Anaconda Division were made by multiplying the Butte estimates . . . "by the number of Anaconda customers to Butte customers," and totalled $58,669.[2] The combined estimates as filed were $300,919. After the hearing the Company revised its estimates to a combined total of $163,143.[3]

MCC did not advocate that the Company not recover its expenses, but took the following position:

> I believe these (S.B. 28 expenses) should be disallowed at this time, as they are not known and measurable. Since there may be considerable financial exposure as a result of Senate Bill No. 28, the PSC should allow BWC to capitalize these expenses and once an annual figure is determined to be representative of a normally

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[1] Docket No. 87.6.30, Direct Testimony of Michael A. Patterson, Applicant's Exhibit 4, p. 4.

[2] Docket No. 87.6.31, Application, 38.5.157, W.P. 6 of 7.

[3] Dockets No. 87.6.30 and No. 87.6.31, Late Filed-Exhibit 3.

> recurring expense, then reflect in rates (1) the annual cost of such repairs, and (2) the amortization of the first year capitalized repair costs over a reasonable time frame.[4]

Based upon this record, the Commission granted the Company's request to recover in current rates its estimated S.B. 28 expenses at the revised levels less an adjustment in the calculation of the estimate for frozen pipe thawing.[5]

ARGUMENT

In its orders, the Commission paraphrased the "known and measurable" rule of section 38.5.106, A.R.M., as follows:

> For a pro forma adjustment increasing or decreasing expenses to be included in rates, it must meet the criteria of ARM 38.5.106 that it is a known and measurable change becoming effective within 12 months of the close of the test period.

If that were an accurate statement of the rule, then the Company's request to include speculative expenses in current rates could conceivably be valid. The rule actually states:

> However, no adjustments shall be permitted unless based on changes in facilities, operations or costs which are known with certainty and

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[4] Docket No. 87.6.30, Testimony of Frank E. Buckley, Exhibit MCC-2, p.4.

[5] Docket No. 87.6.30, Order No. 5331, F.O.F. 27 and 29; Docket No. 87.6.31, Order No. 5332, F.O.F. 26 and 28.

> measurable with reasonable accuracy *at the time of filing*. No adjustment will be entertained unless it will become effective within 12 months of the last month of the test period . . . (emphasis added).[6]

By disregarding the phrase "at the time of filing," the orders have distorted the rule beyond recognition. The applications in these dockets were filed on June 17, 1987. The hearings were held on October 27 and 28, 1987. The late-filed exhibit revising the Company's S.B. 28 repairs estimate was dated and received at MCC on November 20, 1987.

Yet Order No. 5331 and Order No. 5332 accept the Company's estimates as known and measurable changes, stating:

> The Commission agrees with the MCC that the Applicant's original cost estimate of additional expenses did not meet the requirement of measurable with reasonable accuracy. But the revised estimate provided in the late-filed exhibit does satisfy this test.[7]

MCC does not agree that the revised estimates provided an adjustment that was measurable with reasonable accuracy, as evidenced by the wide variation between the original and revised estimates. In addition, if the adjustment did not meet the test, including, as it must under the Commission's own rules, *at the time of filing*, then how can it meet the test over four months after the

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[6] Section 38.5.106, A.R.M.

[7] Docket No. 87.6.30, Order No. 5331, F.O.F. 26; Docket No. 87.6.31, Order No. 5332, F.O.F. 25.

time of filing? The result of the orders is simply absurd. The Commission could just as well say the up is down, and on is off, as to say that the Company's S.B. 28 adjustment is a known and measurable change.

The Commission states, after making these findings,

> The MCC is correct that the exact amount of expenses cannot be quantified at this time and BWC is correct that the utility should be able to recover these expense (*sic*).[8]

If the MCC is correct that the expenses cannot be quantified, whether at the time of filing or at any other time as the Commission seems to want to allow, they should not be recovered in current rates. The Commission offers no reason why the Company's being correct about being able to recover the expenses means they should be able to do so in current rates. MCC offered a means for the Company to recover the expenses, current and future, as soon as they become quantified, an approach which fully comports with the Commission's rules and past ratemaking procedures. The treatment of S.B. 28 estimates in these cases violates the Commission's own rules, and could encourage regulated companies to file for adjustments based on inaccurate or incomplete data with the notion that they can fix up the record at any time, even after the hearing, and have their speculative or incorrect adjustments granted. It also sets an undesirable precedent for the Commission to grant specific amounts of money for speculative expenses in future rate cases.

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[8] Docket No. 87.6.30, Order No. 5331, F.O.F. 28; Docket No. 87.6.31, Order No. 5332, F.O.F. 27.

Further support for the speculative nature of the adjustment is found in the Company's application, where the Company describes how it arrived at its numbers:

> Under the provisions of S.B. 28, passed during the 1987 Legislature, the Company will be responsible for maintaining customer service lines, beginning October 1, 1987. *Estimates* for providing this service have been obtained from local contractors. These are not fixed-fee bids, and are based on the past experience of the contractors involved. For rate-making purposes, the *average* of the *estimates* will be used to *estimate* the actual expense which will be incurred.
>
> In addition, *estimates* regarding the repair of frozen pipes were obtained from local contractors. These *estimates* ranged from $11,500 to $63,000. For rate-making purposes, the *average* of the two *estimates* will be used to *estimate* the actual expense to be incurred (emphasis added).[9]

There are nine references to estimates and averages used in these two short paragraphs describing a single adjustment. This and the drastic reduction in the estimates provided after the hearing demonstrate how far the Company's adjustment falls short of meeting the Commission's known and measurable rule.

In its opening brief, the Company characterized S.B. 28 as " . . . the Montana Legislature's recent excursion into privately owned water utility rate making," and stated:

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[9] Docket No. 87.6.30, Application, 38.5.157, W.P. 6 of 8.

> The problem arises from the fact that the Legislature has established this new operating expense as a known change, but has made no provision for nor suggested how to measure the cost of this known change.[10]

MCC would like to point out that it is not unusual for the Montana Legislature to make "excursions" into utility ratemaking. We also believe that if special ratemaking treatment for these newly imposed expenses had been envisioned, it would have been included in the law. The Legislature has in the past enacted legislation affecting utility expenses, for example, in energy conservation, contemplating inclusion of increased costs in rates after they were incurred, not before.[11] This statement by the Company also articulates very clearly why the Commission should not accept the adjustment, that is, that although it may be known with certainty that the Company will incur increased operating expenses because of S.B. 28, it is not known at all, much less measurable with reasonable accuracy, what the new expenses will amount to.

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[10] Applicant's Opening Brief, p. 5.

[11] Section 69-3-712, M.C.A.

CONCLUSION

For these reasons, MCC respectfully moves that the Commission reconsider its findings on the S.B. 28 issue in Order No. 5331 and Order No. 5332.

Submitted March 11, 1988.

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MONTANA
HELENA DIVISION

* * *

MOUNTAIN WATER COMPANY, Plaintiff, vs. MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, Defendant.	NO. CV-87-92-H-CCL ANSWER BRIEF IN SUPPORT OF DEFENDANT'S MOTION FOR SUMMARY JUDGMENT (Filed Mar. 4, 1988)

INTRODUCTION

Plaintiff Mountain Water Company (Mountain Water) has divided its opening brief into three sections: 1) Facts, 2) Argument that SB 28 is an uncompensated taking of private property for a nonpublic use in violation of the fifth amendment, and 3) Argument that SB 28 violates the equal protection clause of the fourteenth amendment. No argument is made that SB 28 constitutes a bill of attainder and Mountain Water has apparently dropped that claim. The Public Service Commission (PSC) will respond first

to the legal arguments. Second, the PSC will respond the "Facts" section and to certain miscellaneous contentions interspersed throughout Mountain Water's brief.

I.

Mountain Water's first argument is that SB 28 as "an uncompensated taking of private property for a non-public use and violates the 5th Amendment to the United States Constitution." Mountain Water's Opening Brief at 11. As the PSC pointed out in its opening brief, this argument has two parts: First, does SB 28 constitute an uncompensated taking in violation of the fifth and fourteenth amendments? Second, assuming the answer to the first part is no, does SB 28 constitute a taking for a nonpublic use in violation of the fifth and fourteenth amendments? Both of these questions have already been discussed thoroughly by the PSC in its opening brief. Mountain Water does not cast even a shade of doubt on the conclusions reached in that discussion.

A.

It is first necessary to repeat that SB 28 does not constitute an uncompensated taking. The Mountain Water Company is a public utility regulated by the PSC pursuant to Montana law. The PSC recognizes, as it must, that along with the obligation of a public utility to provide adequate service, goes the right of a public utility to be reasonably compensated for the use of its property in

providing the service.[1] SB 28, and exercise of the police power of the State of Montana, imposes a certain obligation on private water utilities. That obligation, along with others imposed by statute and administrative rule, can only be met through the expenditure of water utility property. For the reasonable expenditure of property, the utility must be compensated through rates paid by utility customers. The PSC, of course, sets utility rates. If the PSC sets the rates too low, it is subject to being overturned by the courts on the very fundamental grounds that such low rates do not allow for adequate compensation to the utility for the use of its property. And, of course, inadequate compensation for the use of utility property constitutes a "taking" in violation of the fifth and fourteenth amendments.

It therefore follows, to repeat our opening brief, that SB 28 does not, by itself, constitute an uncompensated taking. SB 28, like all other regulatory rules and statutes that impose costs on utilities, may be administered so as to contribute to a finding of an uncompensated taking. It is at least conceivable that the PSC, in a fit of petulance, could refuse to allow the recovery in rates of any of the reasonable costs associated with SB 28 compliance. If this happened the courts could very well reverse, at least to the degree that such refusal contributed to a finding that the utility was not being allowed to earn a reasonable return on the value of its property devoted to public service. It is also conceivable that the Montana legislature may one day pass a law that both imposes costs on

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[1] Authority for the argument in this section has already been cited in the PSC's opening brief, § IA, pp. 9-14.

utilities, and mandates that such costs will be born by utility stockholders, and not by utility ratepayers. Such a law, assuming it imposed a regulation that amounted to a "taking" requiring compensation, would undoubtedly be declared unconstitutional. But SB 28 , of course, is not such a law. The question of PSC administration of SB 28 is not ripe for review because, to date, there has been no Mountain Water rate case where compliance costs with SB 28 have been an issue.[2] When, and if, SB 28 compliance costs are an issue ripe for review, such review will be made in state courts pursuant to the Montana Administrative Procedure Act, Mont. Code Ann. §§ 2-4-701–711, or other relevant statutes. The PSC can only reiterate the assertion from its opening brief: the charge that SB 28 constitutes an uncompensated taking is false and misleading, and represents a serious misunderstanding of the "taking" issue as it relates to public utility law.

B.

SB 28, even though not an uncompensated "taking", may still violate the fifth and fourteenth amendments if it mandates a taking for a private and not a public use. Mountain Water vaguely cites to several cases which presumably are intended to support the argument that SB 28 constitutes a taking for a private use. The cases cited

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[2] The PSC, as this answer brief was being written, issued an order on an application of Butte Water Company which considered compliance costs with SB 28. It is not known whether Butte Water will appeal the order or whether the PSC treatment of SB 28 compliance will be an issue on appeal.

are either completely irrelevant to our facts or have been distinguished by later authority.

The first citation is to *Pennsylvania Coal Company v. Mahon*, 260 U.S. 393 (1922). This case, as noted in the PSC's opening brief, establishes the Supreme Court's position that there is a continuum of government regulation: toward one end is government regulation that requires no compensation; toward the other is government regulation that so infringes on property interests that it requires compensation through the exercise of the eminent domain power. On the facts in *Mahon* the Court found that compensation was required. That the "taking" involved was for a public use was presumed by the Court and was not even an issue in the case.

Mountain Water next finds an analogy between our facts and the decision in *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980). If there is such an analogy, it escapes the PSC. In *Webb* the Court made a narrow holding that found unconstitutional a Florida law that allowed a county to retain the interest accruing on an interpleader fund deposited with the county pending ultimate dispersal by a court. The Court made the holding only under the particular circumstances extant in Florida where there was a separate statute authorizing the counties to keep a percentage of such funds for services rendered. The language from *Webb*, quoted on page 14 of Mountain Water's opening brief, indicates that the Court is still conscious of the continuum of regulation described in *Mahon*. The Court merely indicates by that language that it has been permissive in finding that much government action that interferes with property interests

does not require compensation. The Florida statute, however, as the language from *Webb* quoted on page 15 of Mountain Water's opening brief indicates, stepped over the line and constituted an uncompensated taking. (There was no question of compensation, of course, because the property confiscated was money.) As in *Mahon*, the question of public versus private use was not raised in *Webb*. Both cases turn on whether the law in question constitutes an uncompensated "taking." Neither case deals with a statute directed at a public utility. As such they are not germane to our case where an uncompensated "taking" is not an issue.

Finally, on the question of public versus private use, Mountain Water cites to the following cases to support the proposition that "when governmental action directly transfers wealth from one private party to another, it is a per se violation of the 5th Amendment, because of the public use limitation." Mountain Water's Opening Brief at 17-18: *Thompson v. Consolidated Gas Utilities Comp.*, 300 U.S. 55 (1936); *Georgia Railway and Electric Company v. City of Decatur*, 295 U.S. 165 (1934); *Interstate Commerce Commission v. Oregon and Washington Railroad Co.*, 288 U.S. 14 (1932); *Chicago, St. Paul, Minneapolis, Omaha Railway Co. v. Holmberg*, 282 U.S. 162 (1930); *Delaware, Lackiawana, and Western Railroad Co. v. Town of Morristown*, 276 U.S. 182 (1927); *Cincinnati v. Vester*, 281 U.S. 439 (1929); *Great Northern Railway Company v. Cahill*, 353 U.S. 71 (1919); *Myles Salt Co. v. Board of Commissioners*, 239 U.S. 478 (1915); *Great Northern Railway Co. v. Minnesota*, 238 U.S. 340 (1915); *Missouri Railway Co. v. Nebraska*, 217 U.S. 196 (1909); *Missouri Pacific Railway Co. v. Nebraska*, 164 U.S. 403 (1896). This litany of cases does not stand for the

proposition submitted by Mountain Water. Rather, these cases support the conclusion "that one person's property may not be taken for the benefit of another private person *without a justifying public purpose*, even though compensation be paid." *Thompson v. Consolidated Gas Utilities Corp.*, 300 U.S. at 80 (emphasis added). The emphasized language is crucial in pointing out the distinction between the real holding of these cases, and the holding attributed to them by Mountain Water.

Nothing in the cases just cited is inconvenient to the argument made by the PSC in its opening brief. There the PSC cited to *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984), a case which acknowledges the line of cases cited by Mountain Water but focuses on what constitutes a "justifying public purpose." The PSC refers the court to page 17 of its opening brief wherein it quotes the language from *Hawaii* that controls this issue. That language states clearly that a court need only find a conceivable public purpose to uphold legislation challenged under the public use clause. On pages 17-18 of its opening brief the PSC argues that the public purpose behind SB 28 is not just conceivable, it is readily apparent. Mountain Water's contention "that it is impossible, logically, to hypothesize a public purpose" for SB 28, is, quite simply, nonsense. Mountain Water's Opening Brief at 15.

C.

In addition to concluding that SB 28 constitutes an uncompensated taking for private use, a conclusion that is demonstrably false, Mountain Water contends that SB 28 "cannot be defended as a simple exercise of the state's

police power over public utilities for which no compensation is due." Mountain Water's Opening Brief at 15-16. Because the PSC does not defend SB 28 on this basis, it is not necessary to respond to the authority cited by Mountain Water. The PSC, of course, defends SB 28 as a valid exercise of the State's police power for which compensation is due through rates in the special context of public utility regulation.

* * *

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MONTANA
HELENA DIVISION

* * *

MOUNTAIN WATER COMPANY,	)	
	)	NO. CV-87-92-H-CCL
Plaintiff,	)	
	)	REPLY BRIEF IN
vs.	)	SUPPORT OF
MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION,	)	DEFENDANT'S MOTION FOR SUMMARY JUDGMENT
	)	
Defendant.	)	(Filed Mar. 31, 1988)

INTRODUCTION

This brief will reply to the arguments made by Plaintiff Mountain Water Company (Mountain Water) in its Brief In Answer To Defendant's Motion For Summary Judgment filed with this court on March 4, 1988. Issues will be addressed in the order presented by Mountain Water.

I.

A.

A person lost on a desert island with only Mountain Water's answer brief for reading material would find it extremely difficult to understand the Public Service Commission's (PSC) argument on the question of whether SB 28 constitutes a "taking" in violation of the fifth and fourteenth amendments. Therefore, before dissecting Mountain Water's misrepresentations of the PSC's position on the question, it might be useful to give a one paragraph review of that position.

To begin with the PSC acknowledges that public utilities are the owners of property (and have rights in that property) which is used in providing utility service. Public utilities are considered to be "affected with a public interest" and thus their activities, including the rates they charge, are regulated by the state. In addition, public utilities have an obligation to provide service; they cannot simply close up shop as can other kinds of businesses. In return for the use of utility property in providing utility service, the courts have proclaimed that regulatory agencies must allow utilities to earn a reasonable return on the value of their property devoted the public service. To not allow the utilities such a reasonable return would be a taking of utility property without compensation in violation of the fifth and fourteenth amendments. SB 28, a legitimate extension of state police power, imposes certain costs on private water utilities in Montana. It forces these utilities to expend a certain amount of their property–to bear certain costs–in order to provide a water utility service. The PSC must, consistent with the fifth and fourteenth amendments, and consistent

with accepted ratemaking procedure, allow these costs to be reflected in rates. How this is done, and whether it has been done lawfully, are subjects of future PSC and possibly state court consideration.[1] There is nothing inherent about SB 28 that precludes its administration by the PSC from complying with the Constitution. Therefore, it would be manifestly in error to hold that SB 28, by itself, is an unconstitutional taking in violation of the fifth and fourteenth amendments.

In responding to this argument Mountain Water reveals that it does not understand the difference between a "taking" in the context of public utility regulation, and a "taking" as traditionally understood to require eminent domain proceedings and direct compensation. Because of this lack of understanding Mountain Water asserts that the PSC does not recognize utility property rights, and asserts that it is the theory of the PSC "that in the case of a utility, the Fifth Amendment provides no protection against the confiscation of the ownership or possession of utility property, but only protection of its income-producing ability, and that utility property can be confiscated with impunity as long as future rates are somehow determined so as reflect the loss." Mountain Water's Answer Brief at 7-8. This is, of course, not true.

The PSC, at the very heart of its argument, recognizes that public utilities have property rights in the assets they employ to provide utility service. It is because utilities

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[1] The PSC has considered SB 28 costs in the case of Butte Water Company in a recent order.

have such rights that the courts have held that the state must allow a reasonable return on those assets or risk running afoul of the Constitution as "taking" without just compensation. The application of the fifth and fourteenth amendments on the "taking" issue makes no sense without a property right; a "taking" without compensation cannot exist absent a right in that which is "taken." Having recognized this, however, it is also necessary to recognize that the "taking" issue in public utility regulation exists in a unique context. A traditional "taking" is better characterized as a confiscation, or an expropriation: the seizing of land for construction of a public highway or building is a good example. That is the kind of "taking" Mountain Water refers to when it writes that, "The Fifth Amendment requires either just compensation to be paid before the taking occurs, or that a later payment must include interest on the principal amount from the date of the taking . . . " Mountain Water's Answer Brief at 5. The PSC does not doubt that this is a correct statement of the law in a traditional eminent domain setting (none of the cases cited to support it deal with the regulation of public utilities). However, it has no relevance to the "taking" issue in public utility law. One of the earliest cases that developed the "taking" issue in the special context of public utility law, and a precursor to the cases cited by the PSC at 10-13 of its opening brief, is *Railroad Commission Cases*, 116 U.S. 307 (1886). In that case the court wrote the following:

> Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; *neither can it do that which in law amounts to a*

> *taking of private property for public use without just compensation, or without due process of law.*

Id., 116 U.S. at 331 (emphasis added). The language, "do that which in law amounts to a taking," is an early recognition that a "taking" in the context of utility regulation, though a violation of the fifth and fourteenth amendments, is a very different sort of animal than a "taking" in an eminent domain proceeding.

Failure to understand the "taking" issue prompts Mountain Water to contend that based on "Commission theory," the state could confiscate a portion of a utility's plant and compensate the utility through rates, rather than through direct compensation. This is indeed a fantastic argument, that, however, has nothing to do with the "taking" issue as it relates to SB 28, a law that does not confiscate utility plant, but rather requires a private water utility to use its assets to provide a utility service. The PSC's guess is that the courts would react to Mountain Water's argument by stating that the seizure of utility property, like the seizure of the property of any other entity or person, must be compensated for directly through an eminent domain proceeding. However, the seizing of utility property for which direct compensation must be made, should not be confused with the use of utility property for utility service, for which another kind of compensation must be made.

The law recognizes, as Mountain Water apparently does not, that the method and measure of compensation due a utility for the use of its property to provide utility service is very different from the compensation due a utility or other entity for the direct seizure of property.

Mountain Water has provided ample citation for the proposition that ratemaking is prospective and cannot provide compensation for past losses. Mountain Water concludes from this that SB 28 is a "taking" in violation of the fifth and fourteenth amendments because compliance with it may cause Mountain Water to suffer losses that it cannot recoup. This does not follow, however, for if it did, the entire ratemaking process, as understood and practiced for over a century, would be unconstitutional. The cases have long recognized that public utilities must suffer certain losses and accept certain gains as part of regulation. No better statement of that principal is made than in *Board of Public Utility Commissioners v. New York Telephone Company*, 271 U.S. 23 (1926), a case cited by Mountain Water. In that case the New York Telephone Company applied to the New Jersey Board of Public Utility Commissioners for a rate increase. The Board investigated and found that though an increase was justified, it would be denied on the basis that excess profits had been earned based on the lawful rates previously in force. The Supreme Court reversed the Board, holding that,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, *the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the

> benefit of future subscribers any part of its accumulations from past operations.

Id. 271 U.S. at 31-32 (citations omitted) (emphasis added). As Mountain Water acknowledges, rates are intended to reflect the estimated cost of service during the time they are effective. If that estimate is high the utility accepts the gain and a regulatory agency cannot force the utility to disgorge the gain for the benefit of future ratepayers. If the estimate is low the utility must absorb the loss and the regulatory agency cannot compensate the utility for the loss in future rates. As noted, this loss does not represent a "taking;" a "taking" occurs, in utility ratemaking, if a regulatory agency sets rates so as not to adequately compensate a utility in the future for the reasonable estimate of costs it has demonstrated it will incur based on an historic test period.

Mountain Water implies that the prohibition on retroactive ratemaking makes it impossible to recover all costs associated with SB 28. Even is this were true it would not mean that SB 28 constitutes a prohibited "taking" because it is a fact of regulation that utilities have to absorb unanticipated costs (thus reducing their rate of return), including costs associated with government action, that are not reflected until later in rates. If, however, it turns out that initial costs associated with SB 28 are not recoverable, the responsibility will lie with Mountain Water management as much as with the prohibition on retroactive ratemaking. Mountain Water knew on March 24, 1987, that SB 28 would become effective on October 1, 1987. Mountain Water thus had more than six months to make an estimate of SB 28 costs and to ask that rates be effective October 1, 1988, to reflect those costs. Instead of

that, Mountain Water filed this lawsuit. The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer no loss as a result of SB 28. But if initial costs of SB 28 are lost as a result of the prohibition on retroactive ratemaking, this will not reflect a "taking," it will reflect the failure of Mountain Water to use the regulatory process available to it.

* * *

AMENDMENT 5

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

UNITED STATES CONSTITUTION

AMENDMENT 14

Section 1. Citizens of the United States.

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Sec. 2. Representatives – Power to reduce apportionment.

Representatives shall be apportioned among the several States according to their respective numbers, counting the whole number of persons in each State, excluding Indians not taxed. But when the right to vote at any election for the choice of electors for President and Vice-President of the United States, Representatives in Congress, the Executive and Judicial officers of a State, or the members of the Legislature thereof, is denied to any of the male inhabitants of such State, being twenty-one years of age, and citizens of the United States, or in any way abridged, except for participation in rebellion, or other crime, the basis of representation therein shall be reduced in the proportion which the number of such male citizens shall bear to the whole number of male citizens twenty-one years of age in such State.

Sec. 3. Disqualification to hold office.

No person shall be a Senator or Representative in Congress, or Elector of President and Vice-President, or hold any office, civil or military, under the United States, or under any State, who, having previously taken an oath, as a member of Congress, or as an officer of the United States, or as a member of any State legislature, or as an executive or judicial officer of any State, to support the Constitution of the United States, shall have engaged in insurrection or rebellion against the same, or given aid or comfort to the enemies thereof. But Congress may be a vote of two-thirds of each House, remove such disability.

Sec. 4. Public debt not to be questioned – Debts of the Confederacy and claims not to be paid.

The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slaves; but all such debts, obligations, and claims shall be held illegal and void.

Sec. 5. Power to enforce amendment.

The Congress shall have power to enforce, by appropriate legislation, the provisions of this article.

28 U.S.C. § 1257. State courts; certiorari

(a) Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court by writ of certiorari where the validity of a treaty or statute of the United States is drawn in question or where the validity of a treaty or statute of the United States is drawn in question or where the validity of a statute of any State is drawn in question on the ground of its being repugnant to the Constitution, treaties, or laws of the United States, or where any title, right, privilege, or immunity is specially set up or claimed under the Constitution or the treaties or statutes of, or any commission held or authority exercised under, the United States.

(b) For the purposes of this section, the term "highest court of a State" includes the District of Columbia Court of Appeals.

28 U.S.C. § 1342. Rate orders of State agencies

The district courts shall not enjoin, suspend or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility and made by a State administrative agency or a rate-making body of a State political subdivision, where:

(1) Jurisdiction is based solely on diversity of citizenship or repugnance of the order to the Federal Constitution; and,

(2) The order does not interfere with interstate commerce; and,

(3) The order has been made after reasonable notice and hearing; and,

(4) A plain, speedy and efficient remedy may be had in the courts of such State.

MONTANA CONSTITUTION, ARTICLE XIII

Section 2. Consumer counsel. The legislature shall provide for an office of consumer counsel which shall have the duty of representing consumer interests in hearings before the public service commission or any other successor agency. The legislature shall provide for the funding of the office of consumer counsel by a special tax on the net income or gross revenues of regulated companies.

MONTANA CODE ANNOTATED, TITLE 2, CH. 4

Part 7

Judicial Review of Contested Cases

2-4-701. Immediate review of agency action. A preliminary, procedural, or intermediate agency action or ruling is immediately reviewable if review of the final agency decision would not provide an adequate remedy.

2-4-702. Initiating judicial review of contested cases. (1) (a) A person who has exhausted all administrative remedies available within the agency and who is aggrieved by a final decision in a contested case is entitled to judicial review under this chapter. This section does not limit utilization of or the scope of judicial review available under other means of review, redress, relief, or trial de novo provided by statute.

(b) A party who proceeds before an agency under the terms of a particular statute shall not be precluded from questioning the validity of that statute on judicial review, but such party may not raise any other question not raised before the agency unless it is shown to the satisfaction of the court that there was good cause for failure to raise the question before the agency.

(2) (a) Proceedings for review shall be instituted by filing a petition in district court within 30 days after service of the final decision of the agency or, if a rehearing is requested, within 30 days after the decision thereon. Except as otherwise provided by state, the petition shall be filed in the district court for the county where the petitioner resides or has his principal place of

business or where the agency maintains its principal office. Copies of the petition shall be promptly served upon the agency and all parties of record.

(b) The petition shall include a concise statement of the facts upon which jurisdiction and venue are based, a statement of the manner in which the petitioner is aggrieved, and the ground or grounds specified in 2-4-704(2) upon which the petitioner contends he is entitled to relief. The petition shall demand the relief to which the petitioner believes he is entitled, and the demand for relief may be in the alternative.

(3) Unless otherwise provided by statute, the filing of the petition shall not stay enforcement of the agency's decision. The agency may grant or the reviewing court may order a stay upon terms which it considers proper, following notice to the affected parties and an opportunity for hearing. A stay may be issued without notice only if the provisions of 27-19-315, 27-19-316, and 27-19-317 are met.

(4) Within 30 days after the service of the petition or within further time allowed by the court, the agency shall transmit to the reviewing court the original or a certified copy of the entire record of the proceeding under review. By stipulation of all parties to the review proceedings, the record may be shortened. A party unreasonably refusing to stipulate to limit the record may be shortened. A party unreasonably refusing to stipulate to limit the record may be taxed by the court for the additional costs. The court may require or permit subsequent corrections or additions to the record.

2-4-703. Receipt of additional evidence. If, before the date set for hearing, application is made to the court for leave to present additional evidence and it is shown to the satisfaction of the court that the additional evidence is material and that there were good reasons for failure to present it in the proceeding before the agency, the court may order that the additional evidence be taken before the agency upon conditions determined by the court. The agency may modify its findings and decision by reason of the additional evidence and shall file that evidence and any modifications, new findings, or decisions with the reviewing court.

2-4-704. Standards of review. (1) The review shall be conducted by the court without a jury and shall be confined to the record. In cases of alleged irregularities in procedure before the agency not shown in the record, proof thereof may be taken in the court. The court, upon request, shall hear oral argument and receive written briefs.

(2) The court may not substitute its judgment for that of the agency as to the weight of the evidence on questions of fact. The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if substantial rights of the appellant have been prejudiced because:

(a) the administrative findings, inferences, conclusions, or decisions are:

(i) in violation of constitutional or statutory provisions;

(ii) in excess of the statutory authority of the agency;

(iii) made upon unlawful procedure;

(iv) affected by other error of law;

(v) clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record;

(vi) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion; or

(b) findings of fact, upon issues essential to the decision, were not made although requested.

2-4-711. Appeals – staying agency decision. An aggrieved party may obtain review of a final judgment of a district court under this part by appeal to the supreme court within 60 days after entry of judgment. Such appeal shall be taken in the manner provided by law for appeals from district courts in civil cases. Unless otherwise provided by statute or unless the agency has granted a stay through the completion of the judicial review process:

(1) if appeal is taken from a judgment of the district court affirming an agency decision, the agency decision shall not be stayed except upon order of the supreme court; except that, in cases where a stay is in effect at the time of the filing of notice of appeal, the stay shall be continued by operation of law for 20 days from the date of filing of the notice;

(2) if appeal is taken from a judgment of the district court reversing or modifying an agency decision, the

agency decision shall be stayed pending final determination of the appeal unless the supreme court orders otherwise.

MONTANA CODE ANNOTATED

69-1-102. Creation of public service commission. A public service commission is hereby created, whose duty it is to supervise and regulate the operations of public utilities, common carriers, railroads, and other regulated industries listed in this title. Such supervision and regulation shall be in conformity with this title.

MONTANA CODE ANNOTATED

69-3-101. Meaning of term "public utility". (1) The term "public utility", within the meaning of this chapter, shall embrace every corporation, both public and private, company, individual, association of individuals, their lessees, trustees, or receivers appointed by any court whatsoever, that now or hereafter may own, operate, or control any plant or equipment, any part of a plant or equipment, or any water right within the state for the production, delivery, or furnishing for or to other persons, firms, associations, or corporations, private or municipal:

(a) heat;

(b) street-railway service;

(c) light;

(d) power in any form or by any agency;

(e) except as provided in chapter 7, water for business, manufacturing, household use, or sewerage service, whether within the limits of municipalities, towns, and villages or elsewhere;

(f) regulated telecommunications service.

(2) The term "public utility" does not include:

(a) privately owned and operated water, sewer, or combination systems that do not serve the public;

(b) county or consolidated city and county water or sewer districts as defined in Title 7, chapter 13, parts 22 and 23; or

(c) a person exempted from regulation as a public utility as provided in 69-3-111.

69-3-102. Supervision and regulation of public utilities. The commission is hereby invested with full power of supervision, regulation, and control of such public utilities, subject to the provisions of this chapter and to the exclusion of the jurisdiction, regulation, and control of such utilities by any municipality, town, or village.

MONTANA CODE ANNOTATED

69-7-101. Municipal utilities – regulation by municipality – limitation. A municipality has the power and authority to regulate, establish, and change, as it considers proper, rates, charges, and classifications imposed for utility services to its inhabitants and other persons served by municipal utility systems. Rates, charges, and classifications shall be reasonable and just and, except as provided in 69-7-102, they may not be raised to yield more than a 12% increase in total annual revenues or, in the case of mandated federal and state capital improvements, the increase may not exceed amounts necessary to meet the requirements of bond indentures or loan agreements required to finance the local government's share of the mandated improvements. Annual revenues must be computed on any consecutive 12-month period for purposes of this chapter.

MONTANA R. APP. P.

Rule 34. Petitions for rehearing.

When, in appeals or special proceedings, it is ordered that remittitur, peremptory writ or judgment issue forthwith, no petition for rehearing will be entertained. In all other cases a petition for rehearing may be filed within 10 days after the decision of the supreme court has been rendered, unless the time is shortened or enlarged by order, and the adverse party shall have 7 days thereafter in which to serve and file objections thereto. Extensions of time will be granted only upon showing of unusual merit, and in no event in excess of 10 days. A petition for rehearing may be presented upon the following grounds and none other: That some fact, material to the decision, or some question decisive of the case submitted by counsel, was overlooked by the court, or that the decision is in conflict with an express statute or controlling decision to which the attention of the court was not directed. Oral argument in support of the petition will not be permitted. Six copies of the petition and six copies of objections thereto, which may be in typewritten form, shall be filed with the clerk.

ADMIN. R. MONT.

38.5.106 ANALYSIS OF SYSTEM COSTS FOR A TWELVE MONTH HISTORICAL TEST YEAR (1) The statement of the cost of service shall contain an analysis of system costs as reflected on the filing utility's books for a test period consisting of 12 months actual experience ending no earlier than 9 months prior to the date of filing of the data required by ARM 38.5.101 and 38.5.105, unless good cause be shown. This analysis shall include the return, taxes, depreciation, and operating expenses, and an allocation of such costs to the services rendered. The information submitted with the statement shall show the data itemized below for the test period, as reflected on the books of the filing public utility. Any proposed adjustments to book costs shall be explained in writing. Such adjustments shall be shown separately and shall be fully supported, including schedules showing their derivation, where appropriate. However, no adjustments shall be permitted unless based on changes in facilities, operations, or costs which are known with certainty and measurable with reasonable accuracy at the time of the filing. No adjustment will be entertained unless it will become effective within 12 months of the last month of the test period as used in this section.

(2)

Supreme Court, U.S.
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No. 92-829

In The

Supreme Court of the United States

October Term, 1992

MOUNTAIN WATER CO.,

Petitioner,

v.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, et al.,

Respondents.

Petition For A Writ Of Certiorari To The Supreme Court Of The State Of Montana

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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58 pp

QUESTIONS PRESENTED

1. Whether the Montana Supreme Court was in error by holding that the Montana Public Service Commission did not violate the fourteenth amendment's requirement of just compensation for property taken for public use when it denied Mountain Water Company certain compensation for money taken by a state statute on the ground that granting compensation through rates would violate the rule against retroactive ratemaking.

2. Whether there is any basis for this Court "to protect the integrity of the federal judicial process" from actions of the Montana Supreme Court or the Montana Public Service Commission.

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OPINION BELOW

The opinion of the Montana Supreme Court, (Pet. App. 1-5), is reported at 835 P.2d 4 (1992).

JURISDICTION

The judgment of the Montana Supreme Court was entered on July 21, 1992. (Pet. App. 6.) A petition for rehearing was denied on August 13, 1992. (Pet. App. 92.) The petition for a writ of certiorari was filed on November 12, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATEMENT

Mountain Water Company (hereinafter "Mountain Water") is a private water utility regulated by the Montana Public Service Commission (hereinafter "PSC"). (Pet. App. 195.) In 1987 the Montana legislature passed Mont. Code Ann. § 69-4-511, requiring private water utilities to pay part of the cost to maintain that portion of customer service lines that runs from the water main to the customer property line. (Pet. 3-4.) In response, Mountain Water filed for declaratory judgment in United States District Court for the District of Montana, seeking declaration that Mont. Code Ann. § 69-4-511, *inter alia*, violates the fourteenth amendment by taking the property of Mountain Water without just compensation. (Pet. App. 81.) The district court held that the statute does not constitute a prohibited taking but that it does impose a

service obligation on private water utilities, "for which [they] will be compensated by an increase in rates if necessary." (Pet. App. 86.)

Mountain Water appealed the decision of the district court to the Court of Appeals for the Ninth Circuit. The court of appeals affirmed, holding that Mont. Code Ann. § 69-4-511 effects a taking of Mountain Water's property, but that in the special context of public utility law compensation comes through the ratemaking process: "Any failure of a rate order to compensate Mountain Water justly for expenses incurred under the liability statute would make the rate order, but not the statute, unconstitutional." (Pet. App. 79.)

In 1989 Mountain Water filed a general rate case with the PSC, including a request to be compensated through rates for expenses incurred in complying with Mont. Code Ann. § 69-4-511. The PSC granted Mountain Water's request to include on-going compliance costs in rates on a prospective basis. The PSC denied Mountain Water's request to include prior period compliance costs in rates on the grounds that granting the request would constitute a violation of the prohibition against retroactive ratemaking. (Pet. App. 28-35.) Mountain Water appealed the PSC decision to the Montana First Judicial District Court. The district court reversed the PSC, finding that the refusal to include prior period compliance costs did not justly compensate Mountain Water for the taking. (Pet. App. 12-18.) The PSC and the Montana Consumer Counsel appealed and the Montana Supreme Court reversed, upholding the rule against retroactive ratemaking and finding that Mountain Water was justly compensated through ratemaking for costs incurred in complying with Mont.

Code Ann. § 69-4-511. (Pet. App. 1, 5.) Mountain Water asks this Court to review this decision of the Montana Supreme Court.

SUMMARY OF THE ARGUMENT

There is no conflict between *Mountain Water I* and *Mountain Water II*.[1] In *Mountain Water I* the court held that Mont. Code Ann. § 69-4-511 does not impose an uncompensated taking; just compensation comes through rate setting. In *Mountain Water II* the court held that the PSC had justly compensated Mountain Water for costs incurred complying with Mont. Code Ann. § 69-4-511; the court held that just compensation does not include retroactive recovery of prior period expenses. In reaching its decision in *Mountain Water II* the court was consistent with its own precedent as well as precedent established by this Court on the Takings Clause in the special context of public utility law.

Mountain Water argues that this Court should grant the requested writ because the decision of the Montana Supreme Court conflicts with *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). In *First English* the Court decided a narrow issue of law:

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[1] In its Petition Mountain Water designated *Mountain Water Company vs. Montana Department of Public Service Regulation*, 919 F.2d 593 (9th Cir. 1990) as "Mountain Water I" and *Mountain Water Company vs. Montana Department of Public Service Regulation, Montana Public Service Commission and Montana Consumer Counsel*, 835 P.2d 4 (1992) as "Mountain Water II." In order to be consistent these designations will also be used in this brief.

just compensation requires compensation for property taken by a land use regulation for the period of time before the regulation has been adjudicated a taking. On the other hand, previous holdings of this Court require compensation through the ratemaking process for takings of public utility property. The Montana Supreme Court properly applied these holdings, and thus there is no conflict between this Court's holding in *First English* and the Montana Supreme Court's decision in *Mountain Water II*. Mountain Water is not entitled to dollar-for-dollar eminent domain type compensation for its costs of complying with Mont. Code Ann. § 69-4-511.

Mountain Water urges this Court to grant the writ to protect the integrity of the federal judicial process. It argues that certain statements made by the PSC before the federal district court and the court of appeals bound it to a particular ratemaking method which it subsequently did not apply. No statements made in the lower federal courts, however, contained any promise of a particular ratemaking treatment or in any way disrupted the integrity of the federal judicial process. The precedent cited in Mountain Water's petition, *Frazier v. Heebe*, 482 U.S. 641 (1987), applies to this Court's supervisory powers over lower federal courts, and does not extend to supervision of a state supreme court.

ARGUMENT

THIS PETITION PRESENTS NO CONFLICT BETWEEN THE MONTANA SUPREME COURT AND THE NINTH CIRCUIT COURT OF APPEALS OVER A FEDERAL QUESTION

In *Mountain Water I* the issue relevant to this petition was whether Mont. Code Ann. § 69-4-511 imposes a taking without just compensation in violation of the fifth and fourteenth amendments. The court of appeals concluded that it did not, finding that while the statute imposes a taking in the form of a utility service obligation, just compensation comes through PSC ratemaking. The court of appeals further concluded that failure to compensate justly for expenses incurred under the statute would make the rate order, but not the statute, unconstitutional. *Mountain Water I*, 919 F.2d at 600-601. (Pet. App. 77-79.)

The statute was not at issue in *Mountain Water II*; rather, the issue was whether a PSC rate order adequately compensated Mountain Water for its expenses incurred under the statute. The Montana Supreme Court ruled that it did. Because *Mountain Water I* and *Mountain Water II* do not contain holdings on the same issue there can be no conflict in the decisions; thus, one of Mountain Water's arguments for granting certiorari is eliminated.

Mountain Water manufactures a conflict in the two cases by reading selectively from *Mountain Water I* and misstating the holding of that case. Mountain Water emphasizes the following language from the court of appeals: "Only if the PSC's rate order fails to compensate

Mountain Water justly for all of its private property dedicated to public use can Mountain Water complain of a violation of its fifth amendment rights." *Mountain Water I*, 919 F.2d at 600. (Pet. App. 78.) Mountain Water interprets the word "all" in this sentence as indicating a holding that just compensation requires recovery through rates of all property taken, notwithstanding the prohibition against retroactive ratemaking. Because the Montana Supreme Court affirmed the PSC's refusal to authorize retroactive recovery of Mont. Code Ann. § 69-4-511 expenses, Mountain Water posits a conflict between *Mountain Water I* and *Mountain Water II*. There are several problems with this argument.

First, the discussion in *Mountain Water I* of the requirements of just compensation in the context of public utility regulation is dicta. The holding of the case on the fourteenth amendment question is simply, 1) Mont. Code Ann. § 69-4-511 imposes a taking for a public use, and 2) just compensation is determined in the ratemaking process. Second, the dicta on the requirements of just compensation in *Mountain Water I* are fully in accord with the conclusions of the Montana Supreme Court in *Mountain Water II*. The court of appeals notes Mountain Water's argument that a taking in the public utility context requires compensation consistent with a typical eminent domain action – and rejects it. The court writes,

> Under Mountain Water's analysis then, the liability statute's taking of these funds necessitates a judicial eminent domain action, just as the taking of a parcel of land would so necessitate. Unlike judicial eminent domain proceedings, Mountain Water points out, PSC rate setting is

> prospective. PSC rate setting therefore, cannot compensate Mountain Water dollar-for-dollar for the funds the utility must transfer to its customers.

Mountain Water I, 919 F.2d at 600. And the court concludes " . . . we note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's 'losses' under the liability statute are not constitutionally significant unless its set rates are 'unjust.' " *Id.* at 601. This is an explicit recognition of the prohibition against retroactive ratemaking and of the fact that just compensation in the context of public utility law does not require dollar-for-dollar recovery for property taken.

Third, it is instructive to note that the court in *Mountain Water I* cites several times to *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). In *Duquesne* this Court was faced with the constitutionality of a Pennsylvania statute that prevented certain prudent utility planning costs from inclusion in rates. Even though the statute made it impossible for all property taken to be specifically recovered in rates, the Court found it constitutional, stating that the only relevant constitutional question is whether a rate order allows a utility to earn a reasonable return on its property devoted to utility service. *Id.* at 307-314. The Court held that individual cost items within a rate case (such as compliance with Mont. Code Ann. § 69-4-511) do not have constitutional dimension. *Id.* In *Mountain Water II* it was not questioned that the PSC rate order gave Mountain Water the opportunity to earn a reasonable rate of return. (Pet. App. 23-25.) Thus, the court's decision in

Mountain Water II is consistent with this Court's decision in *Duquesne*.

In light of the above, Mountain Water's interpretation of *Mountain Water I* is untenable. To give the meaning that Mountain Water suggests to the phrase "compensate . . . justly for *all* of its property dedicated to public use . . . " (emphasis added) would be 1) inconsistent with the totality of the fourteenth amendment discussion in *Mountain Water I* itself, 2) inconsistent with *Duquesne*, and 3) inconsistent with other decisions of this Court as discussed below.

The real issue that Mountain Water raises, in the guise of asserting a conflict between *Mountain Water I* and *Mountain Water II*, is whether the prohibition against retroactive ratemaking is consistent with the fourteenth amendment. As the court of appeals recognized in *Mountain Water I*, the answer is yes. If the answer were to be no, then numerous opinions of this Court and lower courts would be overturned, and the regulation of public utilities, as practiced for over a century, would be radically changed.

This issue was settled long ago, and Mountain Water has provided no reason for this Court to revisit it. In *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 395 (1922) (emphasis added), the Court wrote,

> A company which has failed to secure from year to year sufficient earnings to keep the investment unimpaired and to pay a fair return, whether its failure was the result of imprudence in engaging in the enterprise, or of errors in management, or of omission to exact proper

> prices for its output, *cannot erect out of past deficits a legal basis for holding confiscatory for the future, rates which would, on the basis of present reproduction values, otherwise be compensatory.*

In *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31-32 (1926) (emphasis added), this Court reiterated,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. *If there is no return, or if the amount is less than a reasonable return, the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

These cases dispose of the issue. The Montana Supreme Court has relied on *Galveston* and has established the prohibition against retroactive ratemaking as a rule of law. *Mountain Water II*, 835 P.2d at 6, and Montana cases cited by PSC at Appendix 23a-24a. Mountain Water repeatedly mischaracterizes the rule against retroactive ratemaking as a "policy." (Pet. 15-16.) The prohibition against retroactive ratemaking is not a discretionary policy, it is the law. The decision in *Mountain Water II* was an easy, straightforward application of the law to the facts. It does not warrant further review.[2]

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[2] In both state and federal courts the PSC extensively briefed retroactive ratemaking and the taking issue in the con-

THIS COURT'S HOLDING IN *FIRST ENGLISH* DOES NOT CONFLICT WITH THE DECISION BY THE MONTANA SUPREME COURT

Mountain Water argues that the Court should grant the writ in this case because the decision of the Montana Supreme Court conflicts with this Court's holding in *First English Evangelical Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). Mountain Water states that this Court held in that case that compensation must be paid for past economic losses which amount to a taking and which are incurred as a result of state statutory law. Mountain Water also states that the Montana Supreme Court "ignored" *First English* and denied compensation even though the statute in question had been adjudicated a taking requiring compensation under the fourteenth amendment. (Pet. 11.)

If the Montana Supreme Court "ignored" this Court's holding in *First English*, it may be because Mountain Water did not bring the case to the attention of the court. *First English* was not raised before the Montana Supreme Court, or, for that matter, before any of the lower courts, either state or federal. If that case had been raised before the Montana Supreme Court, however, it would not have changed the outcome.

The reason why *First English* would not have changed the Montana Supreme Court's decision in *Mountain Water II* is that it is simply not applicable to Mountain Water's situation. In *First English*, this Court decided

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text of public utility law. Two of these briefs are attached at Appendix 1a and 17a. Mont. Code Ann. § 69-4-511 is referred to as "S.B. 28" in the brief to the Montana Supreme Court.

a narrow issue, that is, that the just compensation clause requires compensation for property taken by a land use regulation for that period of time before it is determined that the regulation is a taking.

Mountain Water attempts an analogy between the State of California's position in *First English* and that of the State of Montana in this case. It points out that the California courts believed that compensation for a taking did not need to be paid for the period prior to adjudication of a taking because of important policy considerations. (Pet. 17-18.) This Court rejected that position, holding that where the government's activities have worked a taking, no subsequent government action can relieve it of the duty to provide compensation. 482 U.S. at 321. In *Mountain Water II*, according to Mountain Water, the State of Montana has taken its property and deprived it of compensation on the basis of state policy, that is, the "general policy" against retroactive ratemaking. This analogy fails.

The rule against retroactive ratemaking is a rule of law, and cannot be applied at the discretion of the PSC. In addition, the rule is consistent with the fifth and fourteenth amendments, as applied in the public utility context, and as found in *Mountain Water I* and *Duquesne*. Mountain Water argues that *Duquesne* and the traditional public utility takings clause cases cannot "save" the Montana Supreme Court's decision in *Mountain Water II* because the *Duquesne*-type analysis is intended to determine *whether* a taking has occurred, while in this case the taking has already been adjudicated. (Pet. 18-19.)

There is nothing special about the costs imposed by Mont. Code Ann. § 69-4-511, except that Mountain Water took the trouble to have them adjudicated a taking. The PSC never argued that the statute did not take Mountain Water's property. Because state law requires public utilities to provide reasonably adequate service, a utility could have any of its costs of service declared takings and under Mountain Water's theory, have them compensated for other than through the ratemaking process. Costs imposed by Mont. Code Ann. § 69-4-511 are no different than any other costs incurred by Mountain Water. There is simply no reason to treat them as typical eminent domain type takings and require compensation other than through the ratemaking process.

The very case in which Mountain Water's compliance costs were declared a taking recognizes the proper means of compensating Mountain Water for those costs. In *Mountain Water I*, the ninth circuit rejected Mountain Water's attempt to distinguish its case from traditional fifth amendment public utility cases, and stated that the fact that Mountain Water had to seek compensation through PSC rate setting rather than through eminent domain was not of constitutional significance. It also stated that any potential "losses" on the part of Mountain Water under Mont. Code Ann. § 69-4-511 are not constitutionally significant unless its set rates are unjust. (Pet. App. 77-79.) Mountain Water, of course, has never challenged its set rates.

The court of appeals and the Montana Supreme Court have correctly determined that Mountain Water is not entitled to compensation other than through the traditional ratemaking process. The Montana Supreme

Court correctly concluded that rates set by the PSC must be at a level that allows just compensation for any regulation that impairs a utility's property interest. (Pet. App. 3.) Mountain Water is not entitled to typical eminent domain type compensation. The narrow holding of this Court in *First English* is not applicable to costs incurred in compliance with Mont. Code Ann. § 69-4-511, which the Montana Supreme Court correctly determined were to be treated in the traditional ratemaking process. This Court's holding in *First English* does not support granting the writ.

THIS COURT'S "AFFIRMATIVE ROLE" IN THE FEDERAL JUDICIAL PROCESS DOES NOT EXTEND TO SUPERVISION OF THE MONTANA SUPREME COURT; THERE HAS BEEN NO UNDERMINING OF THE INTEGRITY OF THE FEDERAL JUDICIAL PROCESS IN THIS CASE

Mountain Water's third reason given to the Court for granting the writ is that it has an "affirmative role to play in preventing the undermining of the integrity of the federal judicial process." It states that the Court must reverse the Montana Supreme Court's decision if the integrity of the federal judicial process is to be vindicated. (Pet. 22.) In support, Mountain Water alleges that the PSC represented to the federal courts that Mountain Water would be compensated for its compliance costs in the ratemaking process, and that the courts relied on those representations in upholding the validity of the statute. Mountain Water goes on to say that the PSC's "general policy" against retroactive ratemaking was in existence at the time the representations were made in the

federal courts, and that other PSC rules made it impossible for Mountain Water to apply for a rate increase in time to recover the compliance costs in question. (Pet. 19-22.)

The only precedent cited in support of this Court's granting the writ to protect the federal judicial process is a portion of a footnote in *Frazier v. Heebe*, 482 U.S. 641 (1987): "The Court's supervisory power over federal courts allows the Court to intervene to protect the integrity of the federal system. . . . " 482 U.S. at 647 n.7. In *Frazier* the Court considered a lower court ruling upholding a local federal district court rule preventing admission to practice of an attorney who was a member of the state bar but had neither a residence nor an office within the jurisdiction. The Court noted that federal district courts have the discretion to adopt local rules, including rules governing admission to practice before them. Their discretion, however, has limits, including the U.S. Supreme Court's "inherent supervisory power to ensure that these local rules are consistent with 'the principles of right and justice.' *In re Ruffalo*, 390 U.S. 544, 554 (1968)[.]" (other citations omitted). 482 U.S. at 645.

This Court's jurisdiction in *Frazier* was also based upon 28 U.S.C. § 2072, which states: "The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings and motions, and the practice and procedure of the district courts . . . and courts of appeals of the United States in civil actions . . . . " 482 U.S. at 646 n.4. Thus, this Court in *Frazier* was dealing with its powers over lower federal courts in the limited area of practice and procedure. The Court stated, referring to its authority over matters such as rules for

admission to practice, that its authority over state court bars is limited to enforcing federal constitutional requirements. 482 U.S. at 647 n.7. Although this Court's authority to intervene in lower federal court matters to protect the integrity of the federal system is unquestioned, *Frazier* does not support Mountain Water's position that this Court should overturn a decision of a state supreme court for the same reason.

Mountain Water's charges with respect to statements by the PSC before the federal courts, their effect and the supposed conflict between the "general policy" against retroactive ratemaking and other PSC rules must also be addressed here, as they have been thoroughly and repeatedly before the lower courts. Mountain Water charges that the PSC promised the federal courts that Mountain Water would be compensated for all its property taken in compliance with Mont. Code Ann. § 69-4-511, and that the federal courts relied on the promise in reaching their decisions. Mountain Water asserts that the PSC then reneged on this promise by applying the "general policy" against retroactive ratemaking to deny Mountain Water prior period compliance costs. The PSC has responded exhaustively to these charges. (App. 30a-35a, and Pet. App. 29-35.) The Montana district court ignored the charges, (Pet. App. 18), and the Montana Supreme Court found them without merit. The court wrote as follows: "[Mountain Water] argues that the PSC is bound by judicial estoppel. The PSC admitted during the course of the federal litigation that [Mont. Code Ann. § 69-4-511] was a taking and that [Mountain Water] would be compensated through rate-making. However, in making that admission the PSC did not waive application of the rules involved in

rate-making." *Mountain Water II*, 835 P.2d at 6. (Pet. App. 3-4.) Thus, the PSC stands convicted of promising that property taken will be reflected in rates according to the rules of ratemaking. The PSC, of course, did exactly as it promised: it reflected compliance costs in rates according to the rules of ratemaking, which do not permit the recovery of prior period (retroactive) expenses. The federal courts did not rely on a PSC promise, because their decisions were not determined by anything the PSC might do, but to the extent the PSC made a promise to the federal courts, it fulfilled it.[3]

Mountain Water's repeated assertions that the statements made by the PSC to the federal courts constituted a promise of a particular ratemaking treatment simply are not accurate. Rather, the statements were simply straightforward characterizations of the ratemaking process.

Mountain Water was not placed in any sort of regulatory bind by conflicting PSC rules. Nor did the PSC promise any particular regulatory treatment. When

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[3] Though it is of no consequence to this petition, the PSC disagrees with the Montana Supreme Court that it admitted or promised anything to the federal courts with respect to its ratemaking treatment of Mont. Code Ann. § 69-4-511 costs. This is because 1) such a promise or admission was not necessary or germane to the PSC's theory of the case, and 2) the PSC does not speak on rates except in an order following a hearing. However, the PSC certainly does not object to the conclusion of the Montana Supreme Court that the PSC promised to do its job according to law.

Mountain Water chose to wait until June of 1989 to apply for a rate increase, it took the risk of making a proposal to the PSC that could not be granted because of the prohibition against retroactive ratemaking. Nothing in the history of this case indicates that the PSC made misleading or inaccurate statements or promises, or any way disturbed the integrity of the federal judicial process. Neither *Frazier* nor the history of this case offers any reason why this Court should grant the writ sought by Mountain Water.

CONCLUSION

Mountain Water has failed to establish any reason why this Court should grant a writ of certiorari in this case. There is no conflict between the decisions of the Montana Supreme Court and the court of appeals. Nor does the holding of the Montana Supreme Court, which properly upheld the orders of the PSC determining compensation in the ratemaking process, conflict with *First English*. Nothing in the history of the case indicates any interference with the integrity of the federal judicial process or justifies overturning the decision of the Montana Supreme Court.

For these reasons, the PSC and the Montana Consumer Counsel respectfully ask that the writ sought by Mountain Water not issue.

Respectfully submitted this 14th day of December, 1992.

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IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

* * *

MOUNTAIN WATER COMPANY, Plaintiff-Appellant, -vs- MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, Defendants-Appellee.	)	CA NO. 88-4097

* * *

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MONTANA, HELENA DIVISION

* * *

BRIEF OF APPELLEE DEPARTMENT OF PUBLIC SERVICE REGULATION MONTANA PUBLIC SERVICE COMMISSION

* * *

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* * *

II. SECTION 69-4-511 DOES NOT VIOLATE THE FIFTH AMENDMENT PROHIBITION AGAINST UNCOMPENSATED TAKINGS OF PRIVATE PROPERTY FOR A NONPUBLIC USE.

Section 69-4-511 requires private water utilities to pay part of the maintenance cost of a portion of the service lines connected to private utility water mains. Mountain Water argues that this requirement constitutes an uncompensated "taking" of private utility property for a nonpublic use. This argument is without merit.

A. Section 69-4-511 Does Not Mandate an Uncompensated "Taking" of Private Property.

For purposes of this discussion the relevant language from the fifth and fourteenth amendments is as follows:

> No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. Const. amend. V.

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law.

U.S. Const. amend. XIV, § 1. It has been long settled that the compensation clause of the fifth amendment has been incorporated into the fourteenth amendment. *Chicago, Burlington and Quincy R.R. Co. v. City of Chicago*, 166 U.S. 226 (1897), *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980). Therefore, Montana must provide compensation if it acts to "take" private property and such

"taking" is deemed an exercise of the eminent domain power. There can be "takings" under the general state police power for which there need be no compensation. Such "takings" are often accomplished under the general rubric of business regulation. However, in the context of public utility regulation, the state must provide adequate compensation through rates for the use of utility company property for the provision of utility service. Therefore, though the cases rarely speak in these terms, the "taking" of utility property for the provision of utility service is an exercise of eminent domain power and must be compensated (albeit indirectly) under the same principle that a property owner must be compensated if his property is "taken" for the construction of a highway.[11]

Historically, the Supreme Court has taken two conflicting positions on the "taking" issue. In *Mugler v. Kansas*, 123 U.S. 623 (1887), the Court declared that a state may regulate business through the exercise of the police power, but that such regulation does not constitute a "taking" unless property is actually appropriated for the public benefit. In *Pennsylvania Coal v. Mahon Co.*, 260 U.S. 393 (1922), the Court retreated from such a rigid position and held that regulation may impair property interests to such an extent as to constitute a "taking," even where there is not actual physical appropriation of the property. In this view, valid exercise of the police power may

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[11] For an excellent capsule discussion of the "taking" issue see J. Nowak, R. Rotunda, J. Young, *Constitutional Law*, 2d Ed. 493 (1983) and 2 R. Rotunda, J. Nowak, J. Young, *Treatise on Constitutional Law*, § 15.12 (1986). Citation to authority supporting these general comments on "taking" will be made in the following discussion.

constrain property use sufficiently to be judged a "taking," and to require compensation.

There is no question that Montana may validly regulate the service and rates of public utilities, or that such regulation has the potential to constitute a "taking" in violation of the fifth and fourteenth amendments of the United States Constitution. However, it is equally apparent that the "taking" issue, in the context of public utility regulation, is not a question of adequate direct compensation for seizing property or impairing its use, but rather is a question of whether authorized rates provide sufficient revenue to generate a reasonable rate of return on plant devoted to utility service.

An early and important case in this area is *Smyth v. Ames*, 169 U.S. 466 (1897). *Smyth* involved the constitutionality of an act of the Nebraska legislature setting maximum rates to be charged by railroads for the transportation of freight within the State of Nebraska. The Court held that while the State of Nebraska had the power to regulate railroad rates, it could not do so in such a manner as to amount to a taking of private property for public use without just compensation. The Court further held that, though it is not the business of the courts to set initial rates, a determination of whether those rates amount to a deprivation of property is a proper subject of judicial inquiry. *Id.* 169 U.S. at 522-526.

In a later case the United States Supreme Court heard an appeal from the Supreme Court of West Virginia which had upheld an order of the West Virginia Public Service Commission over objections that rates set by the Commission were confiscatory in violation of the fourteenth

amendment. *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923). The Court in *Bluefield* stated the following:

> The question in the case is whether the rates prescribed in the Commission's order are confiscatory and therefore beyond legislative power. Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. This is so well settled by numerous decisions of this Court that citation of the cases is scarcely necessary.

Id., 262 U.S. at 690. The Court went on to reverse the West Virginia Court, holding that the return did not constitute just compensation for the use of the property used to render the service.

In a still later case the United States Supreme Court reversed a ruling of the Ohio Supreme Court affirming an order of the Ohio Public Utilities Commission fixing the rates of a gas company in Lima, Ohio. *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U.S. 63 (1935). In *West Ohio Gas* the Court found that the Public Utilities Commission had reduced the return to West Ohio Gas Co. to the point of confiscation by failing to allow certain operating expenses to be reflected in rates. In reaching that decision the Court wrote: "Our inquiry in rate cases coming here from the state courts is whether the action of the state officials in the totality of its consequences is consistent with the enjoyment by the regulated utility of a

revenue something higher than the line of confiscation." *Id.*, 294 U.S. at 70. Upon concluding in *West Ohio Gas* that the return allowed was confiscatory, the Court remanded to the Ohio Commission to set compensatory rates consistent with the Constitution.

In the landmark case of *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1943), the Court established that whether or not rates are confiscatory does not depend on the particular method used to value utility plant. The Court wrote, "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [2]Natural Gas Act is at an end." *Id.* at 602. The holding in *Hope Natural Gas* was recently reaffirmed in *Duquesne Light Co. and Pennsylvania Power Co. v. David M. Barasch*, 109 S.Ct. 609 (1989). In *Duquesne*, the Court considered a Pennsylvania law that requires that electricity rates be set without taking into account utility expenditures for facilities planned but never built, even though the expenditures were prudent and reasonable when made. The Pennsylvania Supreme Court ruled that the law did not take utility property in violation of the fifth amendment, and the United States Supreme Court agreed. The Court reiterated that, when considering whether or not a "taking" occurs in the ratemaking context, it is the total impact of the rates on the financial integrity of the company that is determinative. The individual components of the rates do not have "constitutional dimension." *Id.* at 617. The Court also referred to the concurring opinion of Justice Brandeis in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276 (1923): "Justice Brandeis accepted

the Smyth v. Ames eminent domain analogy, but concluded that what was 'taken' by public utility regulation is not specific physical assets that are to be individually valued, but the capital prudently devoted to the public utility enterprise by the utilities' owners." *Duquesne*, 109 S.Ct. at 616. Justice Brandeis' analysis of the "taking" issue in public utility law has been accepted by the Court.

Several points are clear from these cases: First, a state legislature, either directly through statute, or through a regulatory commission, can set rates that amount to a "taking" in violation of the fifth and fourteenth amendments. Second, state courts can and do review rates set by regulatory commissions to determine whether they amount to an unconstitutional "taking." Third, a state statute will not be considered an unconstitutional "taking" merely because the costs associated with compliance with the statute by regulated utilities may be disallowed by a regulatory commission. (Or, in the case of *Duquesne*, a statute that forbids a regulatory commission from passing through in rates certain reasonable costs is not an unconstitutional "taking.") It is the act of a state, normally through a regulatory commission, that denies the recovery through rates of a reasonable return on plant devoted to utility service will be determined an unconstitutional "taking."

There is no question that Mountain Water will incur certain operating expenses as a result of compliance with 69-4-511. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased. The Commission, for its part, will scrutinize all of Mountain Water's expenses to determine whether or

not they are reasonable. Reasonable expenses will be added to a reasonable rate of return on Mountain Water's rate base to arrive at the total amount of revenue (revenue requirement) that Mountain Water will be allowed to recover through rates. Once a decision is made on the revenue requirement of any regulated utility, that utility can appeal that decision to the courts. A possible basis for appeal is that the order establishing the revenue requirement constitutes a "taking" in violation of the fifth and fourteenth amendments. But the mere fact that a regulatory commission may disallow recovery of legitimate expenses associated with compliance with a statutory requirement does not render the statute to be complied with inherently unconstitutional. The potential exists that the Commission in an order could disallow legitimate costs of compliance with 69-4-511, which could *contribute* to a finding on appeal of an unconstitutional "taking." But in such a case it would be the action of the Commission that would comprise the unconstitutional "taking;" section 69-4-511 itself would not thereby be rendered unconstitutional.

Therefore, Mountain Water raises a totally false and misleading issue when it charges that 69-4-511 constitutes a prohibited "taking." The regulation of public utilities in the form of both service and rate regulation, is uncontestably within the police power of the states. *See, e.g., Munn v. Illinois*, 94 U.S. 113 (1877). Section 69-4-511, by directing private water utilities to pay for a specific service directly related to the provision of water, is inarguably a legitimate extension of state police power. Not until the Commission has acted on a water utility application that includes costs of complying with 69-4-511, will there

even be the potential for legitimately raising an issue regarding the regulatory treatment of those costs. And, as *Duquesne* makes clear, that issue will not be of "constitutional dimension" unless rates are set so as to deprive the utility of a reasonable return on its investment devoted to utility service.[12]

B. The Arguments in Section B(2) of Mountain Water's Brief are Misleading and Without Merit.

1. The Commission Recognizes that Utilities have a Right to be Compensated for the Use of their Property in the Provision of Utility Service.

Mountain Water's position on the "taking" issue reveals that it does not understand the difference between a "taking" in the context of public utility regulation, just discussed, and a "taking" as traditionally understood to require eminent domain proceedings and direct compensation. Because of this lack of understanding Mountain Water asserts that the Commission does not recognize utility property rights, and asserts that it is the theory of the Commission "that in the case of a utility, the Fifth Amendment provides no protection against the confiscation of the ownership or possession of utility property itself, but only protection of its income-producing

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[12] The Montana Administrative Procedure Act, Mont. Code Ann. § 2-4-701 - 711, allows for the appeal of a Commission order into State district court. Appeal can then be made to the Montana Supreme Court and from there to the United States Supreme Court. The lower federal courts normally have no part in the appeal of orders from state regulatory commissions.

ability, and that utility property can be confiscated with impunity as long as future rates are somehow determined so as reflect the loss." Appellant's Brief at 29-30. This is, of course, not true.

The Commission, at the very heart of its argument, recognizes that public utilities have property rights in the assets they employ to provide utility service. It is because utilities have such rights that the courts have held that the state must allow a reasonable return on those assets or risk running afoul of the Constitution as "taking" without just compensation. The application of the fifth and fourteenth amendments on the "taking" issue makes no sense without a property right; a "taking" without compensation cannot exist absent a right in that which is "taken." Having recognized this, however, it is also necessary to recognize that the "taking" issue in public utility regulation exists in a unique context. A traditional "taking" is better characterized as a confiscation, or an expropriation: the seizing of land for the construction of a public highway or building is a good example. That is the kind of "taking" Mountain Water refers to when it writes that, "The Fifth Amendment requires either just compensation to be paid before the taking occurs, or that a later payment must include interest on the principal amount from the date of the taking . . . ". Appellant's Brief at 28. The Commission does not doubt that this is a correct statement of the law in a traditional eminent domain setting (none of the cases cited to support it deal with the regulation of public utilities). However, it has no relevance to the "taking" issue in public utility law.

One of the earliest cases that developed the "taking" issue in the special context of public utility law, and a

precursor to the cases cited by the Commission at 23-26, *supra*, is *Railroad Commission Cases*, 116 U.S. 307 (1886). In that case the Court wrote the following:

> Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; *neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law.*

Id., 116 U.S. at 331 (emphasis added). The language, "do that which in law amounts to a taking," is an early recognition that a "taking" in the context of utility regulation, though potentially a violation of the fifth and fourteenth amendments, is a very different sort of animal than a "taking" in an eminent domain proceeding. In the latest recognition of this fact the Court wrote that the "partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment." *Duquesne*, 109 S.Ct. at 615.

Failure to understand the "taking" issue prompts Mountain Water to contend that based on "Commission theory," the state could confiscate a portion of a utility's plant and compensate the utility through rates, rather than through direct compensation. *See* Appellant's Brief at 30. This argument has nothing to do with the "taking" issue as it relates to 69-4-511, a law that does not confiscate utility plant, but rather requires a private water utility to pay part of the cost of utility service. The Commission's guess is that the courts would react to Mountain Water's argument by stating that the seizure of utility property, like the seizure of the property of any other entity or person, must be compensated for directly through an eminent domain proceeding. However, the

seizing of utility property for which direct compensation must be made, should not be confused with the directed use of utility property to provide a utility service, for which another kind of compensation must be made.

2. The Prohibition on Retroactive Ratemaking Does Not Affect the Commission's Position on the "Taking" Issue.

Mountain Water has supplied ample citation for the proposition that ratemaking is prospective and cannot provide compensation for past losses. *See* Appellant's Brief at 27. Mountain Water concludes from this that 69-4-511 is a "taking" in violation of the fifth and fourteenth amendments because compliance with it may cause Mountain Water to suffer losses that it cannot recoup. This does not follow, however, for if it did, the entire ratemaking process, as understood and practiced for over a century, would be unconstitutional. The cases have long recognized that public utilities must suffer certain losses and accept certain gains as part of regulation. No better statement of that principle is made than in *Board of Public Utility Commissioners v. New York Telephone Company*, 271 U.S. 23 (1926). In that case the New York Telephone Company applied to the New Jersey Board of Public Utility Commissioners for a rate increase. The Board investigated and found that though an increase was justified, it would be denied on the basis that excess profits had been earned based on the lawful rates previously in force. The Supreme Court reversed the Board, holding that,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, *the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

Id. 271 U.S. at 31-32 (citations omitted) (emphasis added). As Mountain Water acknowledges, rates are intended to reflect the estimated cost of service during the time they are effective. If that estimate is high the utility accepts the gain and a regulatory agency cannot force the utility to disgorge the gain for the benefit of future ratepayers. If the estimate is low the utility must absorb the loss and the regulatory agency cannot compensate the utility for the loss in future rates. As noted, this loss does not represent a "taking;" a "taking" occurs, in utility ratemaking, if a regulatory agency sets rates so as not to adequately compensate a utility in the future for the reasonable estimate of costs it has demonstrated it will incur based on an historic test period.

Mountain Water implies that the prohibition on retroactive ratemaking makes it impossible to recover all costs associated with 69-4-511. Even if this were true it would not mean that 69-4-511 constitutes a prohibited "taking" because it is a fact of regulation that utilities have to absorb unanticipated costs (thus reducing their rate of

return), including costs associated with government action, that are not reflected until later in rates. If, however, it turns out that initial costs associated with 69-4-511 are not recoverable, the responsibility will lie with Mountain Water management as much as with the prohibition on retroactive ratemaking. Mountain Water knew on March 24, 1987, that 69-4-511 would become effective on October 1, 1987. Mountain Water thus had more than six months to make an estimate of 69-4-511 costs and to ask that rates be effective October 1, 1988, to reflect those costs. Instead of that, Mountain Water filed this lawsuit. The Commission has not made a decision on the treatment of Mountain Water's 69-4-511 costs because Mountain Water has not filed an application. If those costs are treated as a capital cost rather than as expense, Mountain Water may still suffer little loss as a result of 69-4-511. If initial costs of 69-4-511 are lost as a result of the prohibition on retroactive ratemaking, this will not reflect a "taking," it will reflect the failure of Mountain Water to use the regulatory process available to it.

3. It is Misleading to Contend that Paying a Portion of the Cost of Service Line Maintenance Amounts to a Sharing of Earnings with Utility Customers.

Mountain Water writes that it "cannot fund its customers' repair and maintenance of their private property without sharing with them its earnings from its utility operations. Those earnings constitute the private property of Mountain Water, and cannot, consistent with the Fifth Amendment, be given to the Mountain Water customer . . . ". Appellant's Brief at 26. In addition to the

questionable, and in any event irrelevant, contention that 69-4-511 mandates the maintenance of private property, this statement is seriously misleading. If a utility is authorized to earn a 10 percent rate of return, and for a variety of reasons reasonable costs of providing utility service increase, causing the utility to earn only 5 percent, then the additional 5 percent return, which the utility was authorized, is forever lost to it due to the prohibition on retroactive ratemaking.[13]

Whenever a utility earns less than its authorized rate of return it is in a sense sharing some of its authorized earnings with its customers. This is so because if rates could be raised to always reflect the authorized return there would never be a difference between authorized return and actual return. But rates cannot be changed instantaneously to reflect every change in utility cost. For that reason there are times when earnings to which the utility would be entitled are left in its customers' pockets. But those potential earnings do not represent a gift to the customer from the utility, because it is not the utility's money until it is paid as a result of a lawful rate. As the Supreme Court said in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. at 31, "The revenue paid by the customers for service belongs to the Company." Revenue not paid to the company, but which would be paid if the lawful rate allowed the company to

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[13] As noted, however, the utility can head off this reduction in earnings if it can reasonably measure an anticipated cost in time to have higher rates in place when the cost occurs. Some costs, of course, cannot be anticipated and that is why utilities often suffer an erosion of their earnings.

earn its authorized return, does not belong to the company. Thus, whenever a utility bears legitimate costs which reduce its earnings below the authorized level, it results in a theoretical gain to the utility's customers. But this gain does not mean that there has been a "taking" of utility property because the utility never had the property to "take."

When a utility is authorized a certain rate of return, it is given the opportunity to earn that return. A utility has a property interest in the return that is earned, not in that which might have been earned. Property may, consistent with the fifth amendment and the regulatory process, be "taken" from utilities in the sense that its use is directed toward providing utility service. But that property is not given to utility customers; rather it is used to provide a service from which the customers benefit. Customers pay for that property (capital), which is "taken" (used), by paying rates which give the utility the opportunity to earn a reasonable return.

NO. 91-446

* * *

IN THE SUPREME COURT OF THE
STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY, a Montana corporation,

Plaintiff and Respondent,

vs.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL,

Defendants and Appellants.

BRIEF OF DEFENDANT-APPELLANT MONTANA PUBLIC SERVICE COMMISSION

On Appeal from the District Court of the First Judicial District of the State of Montana In and for the County of Lewis and Clark, Cause No. CDV 90-607

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B. Fifth Amendment Taking Occurs in a Special Context in Public Utility Law.

The relevant language from the fifth and fourteenth amendments follows: "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V. "[N]or shall any state deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1. The compensation clause of the fifth amendment has been incorporated into the fourteenth amendment. *Chicago, Burlington and Quincy R.R. Co. v. City of Chicago*, 166 U.S 266 (1897), *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980). Therefore, Montana must provide compensation if it acts to take private property and such taking is deemed an exercise of the eminent domain power.[6] In the context of public utility regulation Montana, through the agency of the PSC, must allow adequate compensation through rates for the use of utility company property for the provision of utility service. Therefore, the taking of utility property for the provision of utility service is a special kind of exercise of eminent

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[6] There can be takings under the general state police power for which there need be no compensation. These takings are not accomplished under the eminent domain power, but rather under the general rubric of business, health and welfare regulation. *See Mugler v. Kansas*, 123 U.S. 623 (1887) and its progeny; *also Yellowstone Valley Electric Cooperative, Inc. v. Ostermiller*, 187 Mont. 8, 608 P.2d 491 (1980); *and* for an excellent capsule discussion of the taking issue *see* J. Nowak, R. Rotunda, *Constitutional Law*, 2d Ed. 493 (1983) and 2 R. Rotunda, J. Nowak, J. Young, *Treatise on Constitutional Law*, § 15.12 (1986).

domain power and must be compensated under the same principle (though not in the same manner) that a property owner must be compensated if his property is taken for the construction of a highway.

The courts have long recognized the special meaning of a taking in the context of public utility regulation. In *Railroad Commission Cases*, 116 U.S. 307, 331 (1886) the Court wrote the following (emphasis added):

> Under pretense of regulating fares and freights, the state cannot require a railroad corporation to carry persons or property without reward; *neither can it do that which in law amounts to a taking of private property for public use without just compensation, or without due process of law.*

The language, "do that which in law amounts to a taking . . . ," is an early recognition that a taking in the context of utility regulation, though potentially a violation of the fifth amendment, is different from a taking in a typical eminent domain proceeding. The Court recognized this again in *Smyth v. Ames*, 169 U.S. 466, 522-526 (1897), holding that while the State of Nebraska had the power to regulate railroad rates, it could not do so in such a manner as to amount to a taking of private property for public use without just compensation. Recently, the Court reaffirmed the special context of a fifth amendment taking in public utility law in *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989): "[The] partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment."

Later, the Court recognized "the *Smyth v. Ames* eminent domain analogy, . . . " *Id.* at 309.[7]

Therefore, while it is recognized that public utilities must expend their property to provide utility service,[8] and that this constitutes a special kind of fifth amendment taking, the questions are 1) how are utilities compensated? and 2) what constitutes just compensation? First, utilities are compensated through rates, as opposed to the direct compensation of a typical eminent domain

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[7] The Montana Supreme Court may have obliquely recognized the special context of fifth amendment taking in public utility law. In *Yellowstone Valley Electric Cooperative v. Ostermiller*, 187 Mont. 8, 608 P.2d 491 (1980), the issue was whether a statute requiring the raising of utility lines (by regulated and unregulated utilities) to enable structures to pass, constituted an uncompensated taking. This court held that, "The statute does not involve the appropriation of a property right or a 'taking' under the laws of eminent domain in any traditional sense." *Id.* at 14, P.2d at 495. The court concluded that the statute was an exercise of the police power, necessary to preserve the public welfare, for which no compensation was due. The court recognized (or assumed), however, that compensation would come in the form of rates: "Imposing costs upon utilities and cooperatives is perhaps the most effective way of spreading the burdens created by the statute. In this way, consumers share both the burdens and the general benefits which the statute intended and is calculated to secure." *Id.* at 16, P.2d at 496. The PSC believes that *Yellowstone Valley* was correctly decided because the statute in question does not require an expenditure in the furtherance of utility service. If, however, a statute does require expenditure in the furtherance of utility service (SB 28), then it is clear that such requirement constitutes a fifth amendment eminent domain taking, though not in the "traditional sense."

[8] "Every public utility is required to furnish reasonably adequate service and facilities." § 69-3-201, MCA.

proceeding. Second, just compensation is the opportunity to earn a reasonable return on property devoted to utility service; and the rates that allow that opportunity are prospective in effect.

1. Utilities are Compensated Through Rates for the Taking of Their Property.

The proper method of compensation for a taking in the context of public utility regulation is through rates. "The district court held that Mountain Water's recourse as a utility to obtain just compensation for the property taken under [SB 28] is to seek rate increases before the PSC. We agree." *Mountain Water*, 919 F.2d at 600. The court of appeals also stated, " . . . that Mountain Water must seek just compensation through PSC rate setting rather than through an eminent domain action is not of constitutional significance." *See also Duquesne*, 488 U.S. at 307-315 (and authority cited therein).

2. Just Compensation is Achieved by Setting Rates that Give a Utility an Opportunity to Earn a Reasonable Return on Property Devoted to Utility Service.

To understand what the courts consider just compensation for a fifth amendment taking in the context of utility regulation the PSC reminds this court of the standard formula for setting utility rates: R = O + B(r). *See also* "Background to the Argument," *supra* p. 7. The "R" is the revenue requirement (sometimes referred to colloquially as the "bucket of dollars"); the "O" refers to total operating expenses; the "B" is the rate base, or the capital

investment made by the utility to provide service; and the "r" is the rate of return on capital investment that the utility has the opportunity to earn through rates.

For fifth amendment taking purposes, the only relevant question to ask about the application of this formula is whether rates are set at a level that will allow the utility the opportunity to recover its revenue requirement, which includes a reasonable return on utility investment. If the answer to that question is yes, then for purposes of the fifth amendment the inquiry is over. Subsidiary questions about the particular ratemaking treatment of certain expense or capital items are not relevant to a fifth amendment inquiry if the overall effect of the rates is just and reasonable. *Duquesne*, 488 U.S. at 310-315; *see also Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *see generally* Kolbe and Tye, *The Duquesne Opinion: How Much "Hope" is There for Investors in Regulated Firms?*, 8 Yale J. on Reg. 113, 114-21 (1991).

In the present case neither Mountain Water nor the district court asserted that the rates set by the PSC in Order Nos. 5449a and 5449b were not justly compensatory, on a prospective basis, to allow Mountain Water the opportunity to earn its reasonable revenue requirement.[9] Rather, Mountain Water asserted, and the district court

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[9] As noted, a reasonable revenue requirement includes a reasonable rate of return on capital devoted to utility service. In Docket No. 89.6.23 the PSC approved a total cost of capital of 11.769 percent. Thus, Mountain Water's rates are currently set to provide sufficient revenue to cover all expenses plus a 11.769 percent return on rate base.

held, that the authorized rates constituted a taking without just compensation because they did not permit Mountain Water to recoup prior period SB 28 expenses.[10] The district court holding is clearly in error.

3. Just Compensation Through Rates Does Not Contemplate the Recovery of Prior Period Expenses (Sometimes Referred to as Past "Losses").

Ratemaking is a legislative activity and, therefore, prospective only in its effect. This court has consistently so held. *See State ex rel. Billings v. Billings Gas Co.*, 55 Mont. 102, 110, 173 P. 799, 801 (1918), "As heretofore observed, rate regulation of public utilities is distinctively a legislative function of the state, . . . "; *Billings Utility Co. v. Public Service Commission*, 62 Mont. 21, 33, 203 P. 366, ___ (1921), "It is well-settled law that ratemaking is purely a legislative act, and as such the power of the courts is circumscribed and restrained in interference with determinations reached within the scope of legislative authority."; *Montana Horse Products Co. v. Great Northern Railway*, 91 Mont. 194, 203-4, 7 P.2d 919, 923-24 (1932);

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[10] Prior period expenses are those that are incurred prior to a PSC order (either interim or final). An order establishes new rates that are intended to recover costs, on a prospective basis, that have been determined by a review of a historic test period that includes adjustments for known and measurable changes. The new rates do not recover costs incurred prior to the order; rather, they are designed to match the costs that will occur during the period rates are in effect. *See* "Background to the Argument," *supra*, p. 7.

City of Baker v. Montana Petroleum Co., 99 Mont. 465, 482-83, 44 P.2d 735, 739 (1935),

> Certainly, under the authority to which we have already adverted, it would not be contended that an order of the commission changing the rates to be charged should operate retroactively. As we have pointed out, the charge in question was presumably one of the expense items upon which the rates were based. Hence there is no more reason for holding that an order eliminating that charge should operate retroactively than there is for holding that an order changing the rates should have retroactive effect.

Montana Citizens Freight Rate Association v. Board of Railroad Commissioners, 128 Mont. 127, 132, 271 P.2d 1024, 1027 (1954); *Cascade City Consumers Association v. Public Service Commission*, 144 Mont. 169, 192, 394 P.2d 856, 868 (1964), "This court has pointed out that it is a legislative function to regulate public utilities and that the legislature can do so through an administrative agency."; *City of Polson v. Public Service Commission*, 155 Mont. 464, 476, 473 P.2d 508, 514 (1970); *City of Helena v. Montana Department of Public Service Regulation*, 194 Mont. 173, 182, 634 P.2d 192, 198 (1981), "It is clearly the law that utilities may not set their rates so as to amortize past deficits."

The United States Supreme Court has also clearly held that rates may not recover past "losses." In *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 395 (1922) (emphasis added), the Court wrote that,

> A company which has failed to secure from year to year sufficient earnings to keep the investment unimpaired and to pay a fair return, whether its failure was the result of imprudence

> in engaging in the enterprise, or of errors in management, *or of omission to exact proper prices for its output*, cannot erect out of past deficits a legal basis for holding confiscatory for the future, rates which would, on the basis of present reproduction values, otherwise be compensatory.

Similarly, in *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31-32 (1926) (emphasis added), the court held that,

> The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation, is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, *the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory.* And the law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations.

Also, in *Hope*, 320 U.S. 591, the Court established the standard for a fifth amendment taking in the context of public utility regulation (reaffirmed in *Duquesne*, 488 U.S. at 310). The Court wrote, "It is conceded that under the Act the [Federal Power] Commission has no power to make reparation orders. And its power to fix rates admittedly is limited to those 'to be thereafter observed and in force.' " *Hope*, 320 U.S. at 618. The Court in *Hope* did not find the prohibition against retroactive ratemaking to be inconsistent with just compensation for a fifth amendment taking. Upon such a finding the Court would have

determined the Federal Power Act unconstitutional, which it did not do. *See also Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942).

Finally, in accord with these decisions, in *Mountain Water*, 919 F.2d at 601, the court of appeals wrote, "[w]e note that utilities often in some sense share their accumulated profits with customers when utilities fail to achieve their authorized returns. Indeed, Mountain Water's 'losses' under [SB 28] are not constitutionally significant unless its set rates are 'unjust.' [*Duquesne*], 488 U.S. at 310." Thus, the court of appeals recognized that past "losses" do not raise a fifth amendment problem. A fifth amendment problem occurs only when "set" (prospective) rates are "unjust."[11]

C. Finding an exception to the prohibition against retroactive ratemaking to permit recovery of past SB 28 expenses cannot be reconciled with the law discussed above.

The district court's decision in this case, if affirmed, would not simply create an exception for prior period SB 28 expenses, it would eliminate the prohibition against

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[11] The case law supporting the no past "losses" rule and the prohibition against retroactive ratemaking is extensive and cannot reasonably be cited here. The court is referred to the PUR Digest, 2d and 3d Series, *Rates*, § 86, and the Decennial Digests, Public Service Commissions, key 7.3, (later changed to Public Utilities, key 122). *Also, Michigan Bell Telephone Co. v. Michigan Public Service Commission*, 24 NW.2d 200 (1946) and *Pacific Telephone and Telegraph Co. v. California Public Utilities Commission*, 401 P.2d 353 (1965) are cases containing extensive discussion and citation on the issue of retroactive ratemaking.

retroactive ratemaking. If past "losses" are relevant for purposes of applying the fifth amendment taking clause to public utility regulation, then it follows, not only that there must be an exception to the rule against retroactive ratemaking, but that the fifth amendment *requires* retroactive ratemaking. The logic of the district court holding would make the ratemaking process, as understood and practiced for over a century, unconstitutional. There is obviously no legal support for such a holding.

1. There is nothing special about SB 28 expenses that requires an exception to the prohibition against retroactive ratemaking.

It is simply a fact that utilities often incur increasing costs over time that, absent additional revenues, or cost savings measures, erode earnings and make a rate increase necessary. These increased costs include a myriad of things, many of them unexpected, and over which a utility has limited control. Examples include increased taxes from changes in tax laws, fuel costs, costs to comply with government regulations of various kinds,[12] and other costs driven by general inflation. In the case of Mountain Water, electric power to run its pumps represents a significant cost. Obviously, an increase in the price

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[12] The 1991 Montana legislature imposed a fee on water supply systems to cover certain Department of Health and Environmental Sciences costs. *See* § 75-6-108, MCA. Like SB 28 this fee represents a cost that under traditional principles of ratemaking will not be recoverable retroactively. (Municipal water systems may pass this fee through in rates automatically, but private water providers may not.)

of electricity means an increased cost of providing water service. An increased cost of electricity must be aggregated with other Mountain Water costs (offset by any increased revenues which may come from a growing customer base, and cost savings) in order to determine whether a rate increase is justified.

SB 28 has been upheld as simply another cost of providing utility service. *Mountain Water*, 919 F.2d at 601. It was governmentally imposed, but so are many other costs of providing service.[13] It was not anticipated or known as a cost of service included in Mountain Water's rates, but neither is it known what other unexpected costs will arise to erode earnings. In short, there is very little, if anything, to distinguish the "losses" imposed by SB 28 from the "losses" imposed by other unanticipated costs of service. Therefore, even if the PSC had the power to make an exception and authorize recovery of prior period SB 28 expenses in rates, there was no reasonable basis for such an exception.

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[13] It can be argued that since utilities are required to provide adequate service, virtually all utility costs are governmentally imposed.

NO. 91-446

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IN THE SUPREME COURT OF THE
STATE OF MONTANA

* * *

MOUNTAIN WATER COMPANY, a Montana corporation,

Plaintiff and Respondent,

vs.

MONTANA DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and MONTANA CONSUMER COUNSEL,

Defendants and Appellants.

REPLY BRIEF OF DEFENDANT-APPELLANT MONTANA PUBLIC SERVICE COMMISSION

On Appeal from the District Court of the First Judicial District of the State of Montana In and for the County of Lewis and Clark, Cause No. CDV 90-607

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THE PSC MADE NO REPRESENTATIONS IN FEDERAL COURT CONCERNING RATEMAKING TREATMENT OF PRIOR PERIOD SB 28 EXPENSES; THEREFORE, THE DOCTRINE OF JUDICIAL ESTOPPEL IS NOT RELEVANT TO THIS PROCEEDING.

Mountain Water asserts as a fact that the PSC promised (represented) in federal court to authorize the recovery of prior period SB 28 expenses in rates.[1] Further, Mountain Water asserts as a fact that the federal courts relied on this PSC "promise" when they held that SB 28 is not an uncompensated taking in violation of the fifth and fourteenth amendments to the United States Constitution. Brief of Plaintiff-Respondent at 4, 5, 7, 8 and 10. Mountain Water contends that the PSC reneged on its "promise" by refusing to authorize prior period SB 28 expenses in rates and that such refusal is unlawful as a violation of the principle of judicial estoppel. Mountain Water avers or intimates that the PSC's decision to disallow prior period SB 28 expenses in rates 1) undermines the integrity of the judicial process, 2) violates the obligation to the legal system to act fairly and above reproach, 3) amounts to playing fast and loose with the courts, and 4) is fraudulent. Brief of Plaintiff-Respondent at 10.

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[1] Perhaps on the theory that stating a proposition makes it true, Mountain Water makes this assertion at least 11 times. *See* Brief of Plaintiff-Respondent at 1, 3, 5, 6, 7, 8, 10, 11 and 17.

A serious charge against a government agency requires a serious response – even if, as the PSC believes in this case, the charge is reckless and completely without merit. On four occasions Mountain Water has charged the PSC with reneging on a promise to allow prior period SB 28 expenses in rates: a post hearing brief, a brief in support of a motion for reconsideration, a brief to the district court on judicial review, and its brief filed in this appeal.[2] On each occasion the PSC responded carefully and conscientiously, and will do so again here. *See* PSC Order No. 5449a, appendix document (app. doc.) 10, pp. 10-14; PSC Order No. 5449b, app. doc. 11, p. 7; and PSC answer brief, Montana First Judicial District Court, app. doc. 13, pp. 5-9. (As noted, *supra* at 1, the district court did not address this issue.)

Before applying a principle of estoppel, it is first necessary to determine whether an act has occurred on which to base an estoppel. Whether or not the PSC promised to the federal courts a particular ratemaking treatment of prior period SB 28 expenses is a question of fact and the threshold issue to be determined. If it is determined that the PSC made no such promise, then it is pointless to proceed to consider the application of the legal principle of judicial estoppel.[3] Therefore, the first issue is, what did the PSC state before the federal court?

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[2] In its post hearing brief Mountain Water argued that a decision to disallow *would* renege on a promise. In the other briefs Mountain Water argues that the PSC *has* reneged on a promise.

[3] The PSC presumes that this issue could be remanded back to district court, but contends that, for reasons of judicial efficiency, it should be decided here.

As the PSC noted in its opening brief, the only way to assess PSC communications to the federal courts is to read them. Brief of Defendant-Appellant (PSC) at 28-29. The relevant portions of the PSC's three briefs to the federal district court and brief to the court of appeals are all contained in the Joint Appendix to Briefs of Defendants-Appellants at app. docs. 4, 6, 7 and 9. It is not necessary to argue extensively from these briefs, as they clearly describe the constitutional issue and the PSC's theory of the case. The PSC will, however, respond to the specific examples given by Mountain Water and will identify certain critical language in the briefs.

Mountain Water refers to three passages in PSC briefs that it claims promise to authorize prior period SB 28 expenses in rates:

> There is no question that Mountain Water will incur certain operating expenses as a result of compliance with SB 28. Consequently, the next time Mountain Water applies for a rate increase it will submit those expenses as part of its case that its overall revenue requirement has increased.
>
> It is first necessary to repeat that SB 28 does not constitute an uncompensated taking. The Mountain Water Company is a public utility regulated by the PSC pursuant to Montana law. The PSC recognizes, as it must, that along with the obligation of a public utility to provide adequate service, goes the right of a public utility to be reasonably compensated for the use of its property in providing the service. SB 28, an exercise of the police power of the State of Montana, imposes a certain obligation on private water utilities. That obligation, along with others

> imposed by statute and administrative rule, can only be met through the expenditure of public utility property. For the reasonable expenditure of property, the utility must be compensated through rates paid by utility customers.
>
> The PSC, of course, defends SB 28 as a valid exercise of the state's police power for which compensation is due through rates in the special context of public utility regulation.

Brief of Plaintiff-Respondent at 3-4. These passages cannot accurately be characterized as constituting a promise to authorize prior period SB 28 expenses in rates. The first passage simply expresses the obvious point that the PSC anticipates that Mountain Water will include SB 28 compliance costs as part of its revenue requirement. The second passage is merely a summary of the PSC's argument "that SB 28 does not constitute an uncompensated taking," and a description of adequate compensation in the special context of public utility law. The third passage is yet a more succinct statement of the PSC's argument, correcting Mountain Water's mischaracterization of that argument.

None of these passages contains a promise of particular ratemaking treatment. Moreover, from all the language in the PSC's briefs on the taking issue, it is apparent that the PSC took great care not to convey a promise of particular ratemaking treatment. Consider the following passages from the three PSC briefs to federal district court: "Failure to allow the reasonable costs of compliance with SB 28 to be reflected in private water utility rates could conceivably contribute to a finding, upon review of a decision of the PSC, that those rates are

confiscatory." Opening brief, federal district court, app. doc. 4, p. 6; "With respect to SB 28, the potential exists that the PSC could disallow compliance costs which could contribute to a finding of an unconstitutional "taking." *Id.* at 13; "Not until the PSC has acted on a water utility application that includes costs of complying with SB 28, will there even be the potential for legitimately raising a 'taking' issue, or for seeking the involvement of the courts." *Id.* at 13-14;

> SB 28, like all other regulatory rules and statutes that impose costs on utilities, may be administered so as to contribute to a finding of an uncompensated taking. It is at least conceivable that the PSC, in a fit of petulance, could refuse to allow the recovery in rates of any of the reasonable costs associated with SB 28 compliance.

Answer brief, federal district court, app. doc. 6, pp. 3-4; "The question of PSC administration of SB 28 is not ripe for review because, to date, there has been no Mountain Water rate case where compliance costs with SB 28 have been an issue." *Id.* at 4; "The PSC must, consistent with the fifth and fourteenth amendments, *and consistent with accepted ratemaking procedure*, allow these costs to be reflected in rates. How this is done, and whether it has been done lawfully, are subjects of future PSC and possibly state court consideration." Reply brief, federal district court, app. doc. 7, p. 3 (emphasis added); "The PSC has not made a decision on the treatment of Mountain Water's SB 28 costs because Mountain Water has not filed an application." *Id.* at 8. Similar, if not identical passages may be found throughout the relevant parts of the PSC's brief to the court of appeals. *See* app. doc. 9.

These passages, along with all relevant parts of the PSC briefs to the federal courts, make it plain that the PSC's argument on the constitutional issue presented required no representation of particular ratemaking treatment. The PSC made no such representation in federal court; therefore, it is not necessary to consider the application of the principle of judicial estoppel. The PSC trusts that this court, upon review of the record, will reach the same conclusion.

As noted, *supra* pp. 1-2, Mountain Water also argues that the federal courts relied on promises of particular ratemaking treatment of SB 28 expenses in reaching their decisions. It is not possible to rely on a promise not given. The PSC contends that no reasonable reader of the decisions in question (including those parts of the decisions cited by Mountain Water at pp. 4-5 of its brief) could conclude that the holdings are based on a promise from the PSC of particular ratemaking treatment of SB 28 expenses. The federal courts did not rely on anything; they simply agreed with the PSC on a question of constitutional law.